Revista de Educação e Pesquisa em Contabilidade
Journal of Education and Research in Accounting

Periódico Trimestral, digital e gratuito publicado pela Academia Brasileira de Ciências Contábeis | Available online at www.repec.org.br

REPeC, Brasília, v. 18, n. 2, art. 5, p. 238-259, Apr./Jun. 2024 | DOI: http://dx.doi.org/10.17524/repec.v18i2.3325 | ISSN 1981-8610

The influence of corporate governance on the capital structure of small and medium-sized companies.

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Abstract

Objective: This paper aims to identify how the corporate governance mechanisms adopted by the small and medium-sized clothing manufacturers comprising the Local Production Arrangement (APL) in the Agreste of Pernambuco, Brazil, influence their capital structure. This study is based on the theoretical framework and empirical evidence of the Agency Theory, as well as corporate governance and capital structure.

Method: This quantitative study collected primary data, which were later analyzed using the Mann-Whitney U test, Exploratory Factor Analysis, and the Partial Least Squares Structural Equation Modeling technique.

Results: The companies in the sample adopted 16 (57.14%) of the 28 statements describing governance practices (transparency, accountability, and board of directors). The transparency and accountability variables were statistically significant, showing evidence that these mechanisms influence the companies' capital structure, i.e., they facilitate obtaining debt with third parties (banks), especially in the long term. However, it is worth noting that the effect size was small, indicating that despite their relevance and potential role in attracting external resources, the adoption of these variables is still incipient.

Keywords: Governance; Capital structure; SMEs; Local productive arrangement.

Published in Portuguese and English. Original Version in Portuguese.

Round 1: Received in 5/14/2023. Review requested on 9/18/2023. Round 2: Resubmited on 9/25/2023. Review requested on 11/22/2023. Round 3: Resubmited on 12/6/2023. Accepted on 12/18/2023 by Renato Henrique Gurgel Mota, PhD (Editor assistant) and by Gerlando Augusto Sampaio Franco de Lima, PhD (Editor). Published on 6/29/2024. Organization responsible for the journal: Abracicon.

1. Introduction

Small and medium-sized enterprises (SMEs) play a significant role in global economies (Martinez, Scherger & Guercio, 2019) and are pillars of the Brazilian economy, representing 89.9% of Brazilian formal companies (Sebrae, 2021). A large portion of these firms is grouped into cooperative clusters called Local Productive Arrangements (*APL* in Portuguese). The state of Pernambuco hosts one of the main APLs in the country (Ministry of Tourism, 2015), the *APL de Confecções do Agreste* [Agreste Clothing APL].

An APL is a cooperative cluster where participants work to achieve common objectives (Antero *et al*., 2019). It enables higher production efficiency, increasing firms' ability to sell products in the national and international markets (Tisott *et al*., 2016). Given its relevance, governments give incentives to APLs. For example, the state of Pernambuco implements public policies to boost the development and continuity of these clusters (Iacono & Nagano, 2010; Addiper, 2019; Xavier, 2020). The cities of Caruaru, Santa Cruz do Capibaribe, and Toritama stand out in the *APL de Confecções do Agreste*; as these three cities comprise 8,187 firms in the clothing sector, 5,602 of which are in commerce, 2,480 in industry, and 105 in services (Sebrae, 2021). More significant statistics would be obtained if informal SMEs were also included.

The previous discussion shows that SMEs are significant for the national and local economies. However, some weaknesses in these companies' management hinder their continuity and growth; the average mortality rate of these firms after five years is 60.2% (IBGE, 2019). Difficulties in fundraising are the leading cause of these companies closing in any scenario. Nascimento *et al*. (2013) verified that 89% of the bankrupt small companies in their sample faced difficulties obtaining loans. Araújo, Morais, and Pandolfi (2019) also confirm that a lack of financial planning and bank credit led small businesses to bankruptcy.

Banks are the primary source of external capital for SMEs, which are reluctant to grant credit due to risks. Kumar & Rao (2016) addressed a small population of 1,524 SMEs (2006 to 2013) and found that SMEs depend on short-term debt as they have difficulties accessing long-term debt. The factors responsible for such difficulties are information asymmetry, credit rationing, and a lack of audited financial statements. Mahlawat & Batra (2020) reinforce that small businesses must provide transparent information, as lack of information disclosure is a significant hindrance to accessing external resources.

Due to less rigorous accounting standards, SMEs are characterized by a lack of information transparency (Liu & Yu, 2008). Transparency is one of the principles of good governance, leading to a climate of trust in the organization's relationships with third parties and providing an advantage in attracting external resources (IBGC, 2014). A governance system is intended to increase the quality of information flow. Almeida & Santos (2016) verified that companies listed on BM&FBOVESPA from 2008 to 2012 that provided more information to the market could more easily raise funds through debt.

According to Silva & Leal (2007), the concept of corporate governance applies to all companies seeking a relationship of transparency and trust with the parties with whom they have a relationship. Hence, sound governance principles, such as adequate accounting practices, information disclosure, and having a board of directors, which makes the company more transparent and adequately managed, are believed to increase the confidence of investors and financial institutions, decreasing information asymmetry-related problems, and enabling SMEs to raise funds. Therefore, the following research question guides this study: "**How does corporate governance impact the capital structure of small and medium-sized companies composing the local arrangement of clothing production in the Agreste, PE, Brazil?**"

Regulators, researchers, and governance professionals focus their attention on companies listed on the stock exchange (B3), neglecting SMEs, especially those located in the context of developing economies (Al-Najjar & Al-Najjar, 2017) due to a lack of databases, which is the case of Brazil. Addressing such a gap is essential to expanding financing alternatives for SMEs (Caneghem & Campenhout, 2012; Martinez, Scherger & Guercio, 2019).

2. Theoretical Framework

2.1 Governance in the Context of Small Companies

Traditionally, agency problems concern conflicts of interest caused by the separation between ownership and control. Conflicts stem from the premise that there are divergences of interest due to opportunistic behavior, incomplete contracts, and uncertainty in organizational decision-making (Jensen & Meckling, 1976).

Therefore, it is tempting to believe that such issues addressed by the theory would not apply to small companies, considering that, in general, a single individual has ownership and control (Hart, 1995). However, studies have challenged this traditional view and identified conflicts between owners and creditors (Panda & Leepsa, 2017). Small firms are not required to comply with any disclosure and often do not have the necessary data, such as the history of audited financial statements (OECD, 2017), resulting in information asymmetry, i.e., owners access information their financiers do not (Pindyck & Rubinfel, 2013). Hence, such companies present high bankruptcy rates and agency costs (Michaelas, Chittenden & Poutziouris, 1999), promoting moral hazard and adverse selection.

Matias (2009) considers that adverse selection occurs due to incomplete or uncertain information regarding the credit applicant; i.e., the applicant has information the lender does not and hides it to increase his/her chance of obtaining a loan. Therefore, adverse selection leads to credit rationing when no regulation is available for granting loans (Lazzarini & Chaddad, 2000). Moral hazard refers to agents' hidden actions. It occurs when the borrower diverts credit to other high-risk activities not agreed upon in the contract. These activities offer greater returns on investment but may compromise debt payment (Mishkin, 2000).

Faced with principal-agent problems, organizations move towards adopting governance mechanisms. Corporate governance has the potential to regulate, monitor, and control the behavior of SME managers, reduce moral hazard in the use of capital, improve transparency and accountability, and eliminate asymmetric information between banks and SMEs (Mutamimah, Tholib & Robiyanto, 2021).

Due to information asymmetry, companies suffer pressure from stakeholders, who encourage the disclosure of sufficient and reliable information (Serra & Lemos, 2020). Caneghem and Campenhout (2012) note that the quantity and quality of information in financial statements are positively related to the leverage of SMEs. Quintiliani (2019) also emphasizes the importance of transparency in SMEs accessing external resources, as the results suggest that greater financial transparency enables SMEs to decrease information asymmetry and optimize their capital structure. Furthermore, Erdogan (2018) revealed that SMEs' access to bank loans is affected by the reliability of a company's financial data; a company cannot receive loans unless it reveals its financial position.

SMEs can adopt other mechanisms besides transparency, such as having a Board of Directors (IBGC, 2009). The board of directors' structure is not universal and must be aligned with the SMEs' characteristics (Karoui, Khlif & Ingley, 2017). SMEs have very peculiar types of boards. Due to the lack of separation between ownership and control, in addition to resource restrictions (Parsa, Chong & Isimoya, 2007), a single individual tends to dominate decision-making (Kurniawati *et al*., 2018).

Small firms with a single board model face difficulties because managers lack knowledge regarding management instruments and do not seek to improve their skills and knowledge, inhibiting these firms' growth. This situation occurs because many decisions are intuitive, disregarding accounting statements and relevant management information (Santos, Dorow & Beuren, 2016).

Studies also show that family business councils and informal meetings with shareholders are more important than the board of directors for Italian SMEs (Montemerlo *et al*., 2004). Umrani, Johl & Ibrahim (2015) identified that the head of the family makes decisions in SMEs, as they have characteristics of "top-down" management.

Another form of council that SMEs could adopt is hiring specialized consultancy. Schuster & Friedrich (2017) note that 75% of the interviewed entrepreneurs believe that business consultancy, which provides advice on the most suitable financing alternatives, significantly improves their companies' financial management. Ralio & Donadone (2015) highlight the role of Sebrae in strengthening SMEs by offering management techniques and training, though only 33% of SMEs sought Sebrae's services.

2.2 Capital Structure of Small of Medium-Sized Enterprises

Capital structure (CS) is one of the main lines of research that can promote SMEs' development and ensure their survival, especially in emerging countries with more financial constraints (Martinez, Scherger & Guercio, 2019).

The fundraising restrictions faced by SMEs are similar worldwide. Berger & Udell (1998) surveyed small American firms and found that approximately 70% of their total capital came from the owners' resources, commercial banks, and suppliers. The Brazilian context is no different. Cavalheiro, Vieira & Valcanover (2016) found that most Brazilian businesspeople faced difficulties obtaining external financing, verifying that these companies' primary financing sources were accumulated profits, bank loans, credit cards from friends and family, and personal savings.

Hence, given financial constraints, small companies use internal resources. Such a preference is possibly explained by the Pecking Order theory, which was developed to explain the financing preferences of large companies (Frank & Goyal, 2003; Kumar, Colombage & Rao, 2017).

According to this theory, information asymmetry is one of the fundamental elements influencing a company's financing decisions. Thus, managers have privileged information compared to investors; in SMEs, owners have more information than creditors. This phenomenon explains why companies follow a hierarchy of financing sources (Myers & Majluf, 1984). This theory explains that companies first choose internal financing, then debt, and lastly, the issuance of shares to finance their investments (Myers & Majluf, 1984).

Holmes & Kent (1991) argue that the financing decisions of micro and small businesses follow the same order of priority as in the Pecking Order Theory (Myers & Majluf, 1984). They empirically verified that small businesses make decisions according to the following order: accumulated profits, loans, and capital contributions. However, the above authors note that this financing order is likely to be mandatory in the context of small companies; their preference for using internal resources is partially explained by the owner's desire to maintain control over the company, besides credit restrictions imposed on small companies. Furthermore, a lack of knowledge on the part of most managers about the benefits of debt and the costs involved also impacts this decision.

Additionally, considering the importance and theories that guide the formation of companies' CS, such as the Pecking Order theory, studies seek to understand which characteristics are endogenous to these companies that could influence/facilitate access to credit.

The level of tangibility is considered one of the main factors influencing companies' debt (Öztekin & Flannery, 2012), considering that assets are used as collateral (Kayo & Kimura, 2011), making it easier for companies to have a higher level of debt (Rajan & Zingales, 1995). Tangible assets provide the market with information regarding the quality of a company by decreasing the level of information asymmetry, a relevant aspect for SMEs (La Rocca, La Rocca & Cariola, 2011; Degryse, Goeij & Kappert, 2012).

Companies seek to finance their fixed assets with long-term debt and current assets with short-term debt. SMEs with a low asset structure have greater difficulty accessing short-term debt (Abor & Adjasi, 2007). Therefore, tangible assets have a positive and significant effect on medium and long-term debt but a negative effect on short-term debt (Michaelas, Chittenden & Poutziouris, 1999; Matias, Baptista & Salsa, 2015). The results suggest that SMEs' assets might contribute to minimizing agency problems and asymmetric information, and according to the Pecking Order theory, SMEs with fewer fixed assets need to rely more on short-term debt.

Regarding liquidity, Correa, Basso & Nakamura (2013), Henrique *et. al.* (2017), Carvalho, Ribeiro & Amaral (2018), and Henrique, Silva & Saporito (2021) found that the current liquidity index strongly influences debt. The results showed a negative relationship between liquidity and debt, confirming the Pecking Order theory. Pereira *et al.* (2015) used the general liquidity index in the context of small businesses. They found a negative sign between general liquidity (GL) and Short-Term Debt (STD), indicating that the SMEs in the sample had more STD to pay their obligations because they have high liquidity problems.

3. Methodological Procedures

This study is based on objectivist logic and quantitative perspective.

The study sample comprised SMEs registered with the Brazilian Federal Revenue Service (FRS in Portuguese) located in Caruaru, Santa Cruz do Capibaribe, and Toritama, PE, Brazil, which comprise the clothing APL. This APL comprises 8,187 companies from sectors related to the apparel industry, 5,602 from commerce, 2,480 from industry, and 105 from the service sector (SEBRAE, 2021). Thus, non-probabilistic sampling, characterized by accessibility or convenience, was adopted. A total of 382 companies were visited, and 102 consented to participate, i.e., 26.7% of return rate. The most relevant aspect that influenced the number of responses was the content of the items included in the form, as several businesspeople feared that the information would be disclosed to the public.

The small and medium-sized companies addressed here do not have a single definition for SMEs in the academic context. Therefore, the Sebrae and BNDES classification was adopted (Table 1).

Table 1

Company size definition

Size	Economic activities	
	Industry	Gross revenue
Small	From 20 to 99 people	Above R$360,000.00 up to equal to or below R$4,800,000.00
Medium	From 100 to 499	Above R$ 4.8 million up to equal to or below R$ 300 million

Source: Sebrae (2021).

Gross revenue was the criterion chosen to determine the companies' size. The reason is that most firms outsource a portion or all of their production and do not have employment contracts; hence, a classification based on the number of employees was the least recommended.

Primary data were the main source adopted in this study. Hence, a structured form divided into 3 sections was used to collect data. The objective was to understand the characteristics of SMEs concerning social information, financing sources, and governance mechanisms.

Two Ph.D.s teaching in undergraduate programs in Business Administration and four doctoral students in the Administration and Accounting field assessed the questionnaire to verify whether the items adequately addressed the topics under study. A businesswoman from Caruaru also analyzed the form and made contributions concerning the nature of the questions. Furthermore, two bank managers, one of whom is a Master's student at the Federal University of Pernambuco (UFPE in Portuguese), working in a public and a private bank assisting legal entities, assessed the form's language and verified whether the questions were related to this study's objectives. Next, 26 account managers assisting legal entities in 11 banks assessed the questionnaire and confirmed that the form items reflected the context of small businesses. They did not suggest adding questions.

This assessment was important to improve the quality of the questionnaire, which was later pretested in four small companies. The objective was to ensure no dubious questions, problems understanding academic language, or an inappropriate sequence of questions. The participants took from 20 to 30 minutes to complete the form.

Finally, the validation process was implemented (Cooper & Schindler, 2003). This step is intended to ensure that the instrument measures what it is intended to, determining how precisely it represents the concepts (Cooper & Schindler, 2003; Brewer & Hunter, 2006, Hair *et al.*, 2009), which can be verified through Cronbach's alpha (Cooper & Schindler, 2003; Field, 2009). The Cronbach's alpha found here was 0.918, indicating very good internal consistency (Pestana & Gageiro (2008).

3.1 Operational Definition of Variables and Data Analysis

Table 2 presents the companies' long-term debt and total debt indexes used to measure the dependent variable, Capital Structure (CS).

Table 2

Operationalization of the dependent variable

Variable		Proxy	Description	References
Long-term debt	NCL =Non-current liabilities CA = Current Assets NCA = Non-current assets	NCL/ (CA+NCA)	Ratio of long-term debts to total assets	Avelar *et al*. (2017)
Total debt	CL = Current liabilities NCL = Non-current liabilities CA = Current Assets NCA = Non-current assets	(CL+NCL)/(CA+NCA)	Ratio of total debts to total assets	Avelar *et al*. (2017)

Regarding the independent variable related to governance, there is a need to adapt governance principles and mechanisms to the small business context. Thus, the identification of governance principles and mechanisms was based on the few studies addressing governance within the scope of SMEs and the context of the companies comprising the clothing APL; hence, it focused on information transparency. The objective was to observe the quality and quantity of information intended for accountability by preparing reports to creditors and improving decision-making based on information and the board of directors, the primary internal corporate governance mechanism, which contributes to better decision-making, especially in terms of financial resources management (Silveira, 2010).

Therefore, governance was measured through 28 statements rated on a 5-point Likert scale distributed into transparency, accountability, and Board of Directors. According to the literature review, tangibility and liquidity, traditionally identified as determinants of a company's CS, were also included (Table 3).

Table 3

Operationalization of the independent variable

Traditional Variables				
Tangibility	FA = Fixed asset TA = Total assets	FA/TA	Ratio of fixed assets to total assets	Michaelas, Chittenden e Poutziouris (1999)
Liquidity	CA = Current asset CL = Current liabilities	CA/CL	Ratio of current assets to current liabilities	Pereira *et al*. (2015)
Variable – Corporate Governance				
Statements T. 1 – 12 - Transparency (T1) precise information (T2) complete information (T3) regarding guarantees, (T4) risks, (T5) other debts, (T6) relevant changes in the business, (T7) all necessary information, (T8) beyond the mandatory, (T9) planning regarding the purpose of requesting credit, (T10) reliable information regarding how the loan will be used, (T11) the business' plans for the future, and (T12) reliable information about the business.				IBGC (2014, 2009), Cavalheiro, Vieira & Valcanover (2016); Erdogan (2018).
Statements Acc 1 – 10 – Accountability (Acc1) Reports on cash management, (Acc2) annual financial plan, (Acc3) balance sheet, (Acc4) Income Statement, (Acc5) clear division between the company's and the owners' budgets and financial flow, (Acc6) planning on how to face threats, (Acc7) management of credit granted to customers, and (Acc8) granted by suppliers, (Acc9) projections of financial statements, and (Acc10) the company's economic and financial situation.				Caneghem & Campenhout (2012) and Dube, Dube & Mishra (2011).
Statements BD 1 – 6 – Board of Directors (BD1) Family or management advisory board to support more important decision-making, (BD2) with academic and technical skills, (BD3) with skills that can support the company's prospects, (BD4) with market experience, (BD5) older and experienced, and (BD6) support from an external consultancy.				IBGC (2014, 2009); Machado et al. (2013); Compagno, Pittino & Visintin (2005); Jain & Gumpert, 1980; Abor & Adjasi (2007).

Source: developed by the authors.

Due to the nature of data, tests that do not require the assumption of data normality, i.e., non-parametric tests, were adopted, as these are more adaptable to studies involving nominal and ordinal variables. The Mann-Whitney U test was used to verify the research hypothesis, i.e., whether there is a significant difference between the capital structure of companies adopting governance mechanisms and those that do not.

Exploratory Factor Analysis (EFA) was used to identify the existence of not directly observable structures through the set of statements on governance. EFA is a statistical technique that verifies the correlation between many variables, allowing data to be decreased by identifying the most representative variables or creating a set of variables much smaller than the original (Hair *et al*., 2009).

Hair *et al*. (2009) note that it is difficult to perform an EFA with a sample below 50 observations, and as a general rule, at least five times more observations than the number of variables analyzed is required. We attempted to meet the EFA assumptions. Hence, this study's total sample comprised 102 companies, but only 70 acquired bank resources, and 32 never requested financing. For this reason, the 70 companies comprised the sample and answered all the governance items; hence, we complied with the minimum of 50 observations.

However, the second criterion regarding the 5 observations for each variable was not met due to difficulties accessing the companies. Nevertheless, as argued by Field, Miles & Field (2012), small samples may be appropriate if all variables present communality greater than 0.6 (Hair *et al*., 2009).

Data analysis also included the application of the Partial Least Squares Structural Equation Modeling (PLS-SEM), considering the assumption that small samples (less than ~100 cases) are viable and suitable for the theory supporting causal relationships that are not very well rooted yet and can be used for "exploratory" purposes, like in this study. The technique allows for samples of less than 10 cases per model parameter and data sets that do not meet the normality assumption (Hair *et al*., 2013; Bido & Silva, 2019).

4. Analysis and Discussion of Results

This section presents the questions addressing the profile of the interviewees and respective companies. Initially, due to the financial nature of most questions, the forms were to be given only to those with general knowledge of the company, to ensure the most reliable answers possible. Hence, we first aimed to contact the companies' owners (partners), and the managers were the next best option when the owners were not available.

The results show that most respondents (75.5%) were the companies' owners, and only 24.5% of the individuals were managers.

Table 4

Overview of the profile of respondents and characteristics of SMEs

Respondent's Role/Position	
Owners	75,5%
Managers	24,5%
Gender	
Male	61,8%
Female	37,3%
Others	0,98%
Responsible for the financial department	
Owner	81,37%
Family member	6,86%
Partner	4,90%
Accountant	2,94%
Others	3,93%
Idade dos respondentes	
Mean	37,5
Standard deviation	11,37
Academic background	
BA of Business Administration	48,98%
BA of Accounting	10,20%
Bachelor of Laws	10,20%
Others (14 fields)	30,62%
Company's size	
Small	92%
Medium	8%
Company's sector	
Apparel	79,41%
Textile	15,69%
Washing and Finishing	4,9%

Educational Level	
Incomplete Middle School	6,86%
Complete Middle School	5,88%
Incomplete High School	6,86%
Complete High School	32,35%
Some undergraduate studies	14,71%
Undergraduate Degree	29,41%
Specialization or Graduate Studies	3,92%
Corporate Composition	
Number of partners	
Sole owner	63,73%
One partner	24,51%
Two partners	8,82%
Three of more	2,94%
% Majority partner	
Up to 50%	75,68%
More than 50%	24,32%
No. of workers and Market Experience	
Mean of workers	13,42
Standard Deviation	17,1
Mean experience	13,25
Standard Deviation	11,56
Business experience (years)	
Mean	13,61
Standard Deviation	9,79
Cities	
Caruaru	47%
Santa Cruz do Capibaribe	46%
Toritama	7%

Source: study's data (2022).

The profile of the SMEs' managers shows that most were the companies' owners (75.5%), male (61.8%), aged 37.5 on average, had attended higher education (48.5%), in Business Administration (48.98%), and had 13.61 years of business experience on average.

Hence, on average, these managers had 13 years of experience managing a company in the apparel sector (79.4%); the companies had 13 employees on average and were located in Caruaru (47%) or Santa Cruz do Capibaribe (46%). Furthermore, most companies (92%) were small, with ownership centered on their founders, i.e., a single person controls 100% of the capital of 63.72% of the companies, a common characteristic among these companies (Hart, 1995). Such concentration is reinforced in business management, especially the financial area, which is owner-managed (81.37%).

Regarding educational level, academic training has been increasingly valued. A previous survey in this same APL found that only 29% of respondents had attended or completed higher education (Ramos, Santos & Vasconcelos, 2017). Currently, virtually half of these companies are managed by individuals with an academic specialization and/or technical experience. Some interviewees reported that the academic background of managers has increasingly changed after a UFPE campus was installed in Caruaru. It is also noteworthy that some managers reported that qualification has intensified in the second generation, with the owners' children preparing to take over the companies and, in some cases, having already assumed the role of managers.

Regarding these companies' age, the results show that most, 70.6%, managed to stay in the market for at least 5 years. According to IBGE (IBGE, 2019), the first five years are critical for a company's survival, and 48.1% of the companies addressed here exceeded 10 years on the market.

4.1 Results of the Structural Equation Modelling

This section presents an analysis using structural equation modeling to verify whether the governance mechanisms adopted by the SMEs in the Agreste clothing APL have influenced their capital structure.

The variables were inserted into the structural equation model using the factors defined by Exploratory Factor Analysis (EFA). Due to the sample size, EFA was performed to consider only variables with communality >0.60 (HAIR *et al.*, 2009). For this reason, the statements concerning transparency (T3, T9), accountability (Acc1, Acc5), and Board of Directors (BD5, BD6) were discarded (Table 3).

A KMO of 0.770 was found, showing the statements' good degree of explanation based on the EFA's factors. The Bartlett's sphericity test, which resulted in 253.507, indicates sufficient correlations between the statements in the EFA, with a statistical significance level of 5% (sig.<0.05). EFA generated 5 factors from the three governance mechanisms indicated in this study (see Table 3), with transparency (T) subdivided into Disclosure (T- 4, 5, 6, 8, 10 and 11) and Seriousness (T- 1, 2, 7 and 12); accountability (Acc) subdivided into Basic Reports (Acc - 2, 3, 4, 9 and 10) and Extra Reports (Acc - 6, 7 and 8), and Board of Directors (BD -1, 2, 3 and 4) represented by a single factor.

Next, the long-term debt level was the dependent variable in the Structural Equation Modeling (SEM). The first aspect to be considered in the analysis of the model's adjustment was Convergent Validity, verified through the Average Variance Extracted (AVE), which must be greater than 0.50, assuming the model converges to a satisfactory result (Fornell & Larcker, 1981).

The results show that one of the constructs presented an AVE<0.50. Hence, three variables were removed (Basic reports - Acc - 2, 4, and 9) for presenting low factor loadings (Table 3).

After adjusting the model according to AVE, the second step was to ensure Convergent Validity through Internal Consistency (Cronbach's Alpha) and Composite Reliability (CR). Both Cronbach's alpha and CR assess whether the sample is bias-free, i.e., whether the responses are reliable. Cronbach's alpha was above 0.60 and 0.70, which is considered adequate in exploratory research, and CR was equal to 0.70 and 0.90, which is considered satisfactory (Hair *et al.*, 2014). Table 5 shows the adequate Cronbach's alpha and CR.

The third stage was assessing the SEM's discriminant validity (DV), which indicates that the constructs or latent variables are independent (Hair *et al.*, 2014). There are two ways to verify it: by observing cross-loadings – indicators with factor loadings higher on their respective variables than on others (Chin, 1998), and the Fornell & Larcker (1981) criterion, in which the AVE's square roots must be greater than the correlations between the constructs, which was also met (Table 5).

Table 5

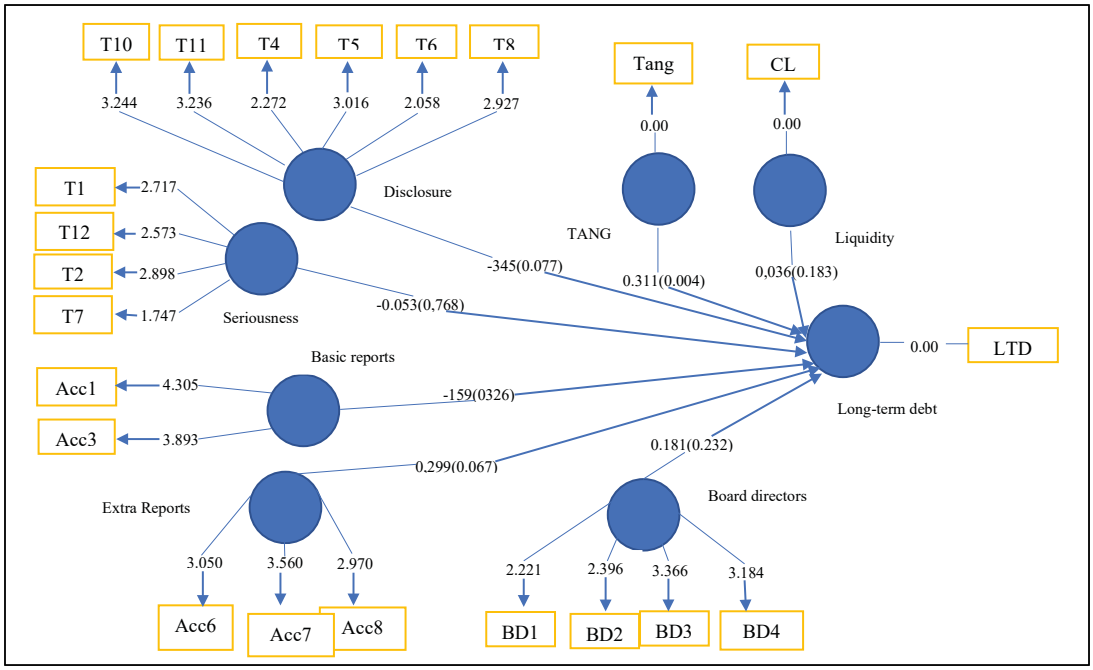
Results of the model assumptions for the LP indebtedness variable

Latent variables	1	2	3	4	5	6	7	8
1. Board Directors	**0,790**							
2. Bank debt	0,204	**1,000**						
3. Liquidity	-0,037	0,094	**1,000**					
4. Basic reports	0,279	-0,100	0,142	**0,907**				
5. Extra reports	0,171	0,089	-0,239	0,384	**0,858**			
6. T. Disclosure	0,141	-0,265	-0,109	0,388	0,340	**0,730**		
7. T. Seriousness	0,233	-0,180	-0,008	0,365	0,110	0,491	**0,756**	
8. TANG	0,276	0,247	0,072	0,095	-0,081	0,187	0,088	**1,000**
Cronbach's alpha	0,844	1,000	1,000	0,786	0,854	0,855	0,822	1,000
Composite Reliability	0,867	1,000	1,000	0,902	0,893	0,872	0,838	1,000
AVE	0,623	1,000	1,000	0,822	0,736	0,533	0,572	1,000

Note 1: the diagonal values are the square root of AVE.
Note 2: the three reliability measures were kept.

Adjustments to the model were completed after ensuring Discriminant Validity. Hence, we proceeded to analyze the structural model. The first analysis of this second stage concerns assessing Pearson's coefficients of determination (R^2). R^2 assesses the variance of the portion of the endogenous variables explained by the structural model.

For the social and behavioral sciences field, Cohen (1988) suggests that R^2 = 2% be classified as a small effect, R^2 = 13% as a medium effect, and R^2 = 26% as a large effect. Regarding the effect size, f^2 = 0.02=small; f^2 = 0.15=medium; f^2 = 0.35=large. The effect size (f^2) obtained in the model addressed here is small, while the variance explained was of moderate impact (adjusted R^2 = 18.4%).



Note: the figures outside parentheses are standardized structural coefficients (betas), while figures between parentheses refer to p-values.

Source: developed by the authors.

Figure 1. Model for Long-Term Debt variable

Three hypotheses were confirmed, with tangibility at a 5% level ($p<0.05$) and disclosure and extra reports at a 10% significance level. The statistically significant relationship identified with the asset tangibility variable was positive. The Beta value (0.311, $p=0.004$) shows that the higher the number of a company's assets, the easier it is to obtain a long-term loan.

The results corroborate those found by Michaelas, Chittenden & Poutziouris (1999), and Matias, Baptista & Salsa (2015), as tangibility is positive with long-term debt. This positive association is explained by the fact that tangible assets minimize agency problems and information asymmetry that small companies usually face. As noted by bank managers, long-term debt requires a more significant amount of information. However, SMEs have restrictions regarding the level of tangibility, and having fewer fixed assets than large companies, they more frequently rely on short-term debt. Given these limitations, managers must provide more information to creditors as a form of guarantee and to enable creditors to assess the firms' financial situation.

The disclosure variable linked to the principle of transparency is marginally significant and negatively associated (*Beta* -0.345, $p=0.077$) with indebtedness and is related to the companies' risk. It includes items T4) The risk linked to the business, T5) the company's other debts, T6) Information about changes in the business, T8) Information beyond that required by banks, T10) Correct information about how the loan will be used, and T11) Information regarding the business prospects.

This negative relationship is possibly related to the quality and quantity of information, as small firms often provide incomplete or uncertain information and, often, the borrower diverts credit to other high-risk activities not previously agreed upon in the contract (Mishkin, 2000; Matias, 2009). Additionally, small businesses are not required to comply with any disclosures and often do not have the data needed, such as historical audited financial statements (OECD, 2017). Furthermore, these firms are more intensively exposed to financial risks (Ang, 1991). Identifying and measuring such risks allows creditors to mitigate potential consequences (Crouhy, Galai & Mark, 2004); however, depending on a company's risk level, it may face greater difficulty when trying to raise funds, especially long-term loans.

A marginally significant positive association was found between extra reports (accountability) and long-term debt, indicating that such reports help attract long-term resources (Beta value=0.299; $p=0.067$). These reports show how long a company is financed by its suppliers and how long it needs working capital financing to make plans. The other report composing this factor presents the plan to face environmental crises, i.e., how the company would behave under adverse circumstances, how it would respond to minimize the negative effects of a crisis, and how it would remain on the market. Such a report is essential because it provides creditors with information about the company's actions in an adverse scenario, allowing them to assess and decrease the risk of stakeholders not receiving the return of the requested capital.

These reports also allow creditors to access the organization's routine and verify its financial situation in the short term. A considerable portion of the SMEs (41.2%) analyzed here showed that they can first receive payments from their customers and then pay their suppliers, keeping the company in a favorable situation. Hence, these companies' suppliers are financing them in the short term. As a result, SMEs more frequently rely on short-term debt to finance their activities over the same period, indicating that these companies have an easier time honoring their financial commitments.

Attempting to confirm this finding, all companies, regardless of having requested bank loans, were asked whether they had prepared any financial reports. A comparison between the two groups indicated that the companies requesting bank loans prepared more reports than companies that never applied for a loan (Table 6).

Table 6

Reports prepared by the firms in the sample.
Distribution of the set of Elaborated Reports, Not Elaborated Reports, and Unknown between the companies that submitted for a loan (Loan) and companies that did not submit for a loan (No Loan).

Reports	Elaborated		Not Elaborated		Unknown	
	Loan	No Loan	Loan	No Loan	Loan	No Loan
1) Reports on cash management	44	15	26	14	0	3
2) Annual financial planning	29	11	41	19	0	2
3) Balance sheet	43	16	27	15	0	1
4) Income Statement	44	17	26	13	0	2
5) Division of the company's and owner's resources	31	11	39	19	0	2
6) Cash flow projection	28	8	42	22	0	2
7) Plan to face environmental threats	15	9	55	22	0	1
8) Projections of financial statements	44	10	26	20	0	2
9) The company's economic-financial situation	47	10	23	20	0	2

Source: developed by the authors.

Companies that applied for a loan prepared 8 of the 9 reports. Statistical tests were performed to verify whether there was a difference between the number of reports prepared by these companies and those that did not apply for loans. The non-parametric Mann-Whitney U test was used due to the non-normality of the data.

Table 7 shows a difference between the groups, i.e., the companies that applied for bank loans prepared a higher number of reports, presenting a mean rank equal to 56.06, while those that did not presented a mean rank of 41.53.

Table 7

Mann-Whitney U Test ranks

	Bank Loan	N	Mean Rank
No. of Reports	Did not submit for a loan	32	41,53
	Obtained a loan	70	56,06
	Total	102	

Source: developed by the authors.

The p-value below 5% (Table 8) shows a statistical difference between the groups. There is evidence that companies that apply for credit are more transparent and prepare more reports, allowing creditors to assess the firm's risk and financial situation. A firm cannot receive a loan unless it reports its actual financial position (Erdogan, 2018).

Table 8
Mann-Whitney U Test

Bank Loan	No. of Reports
Mann-Whitney U Test	801,000
Wilcoxon W	1329,000
Z	-2,314
Asymp. Sig. (2-tailed)	0,021

Source: developed by the authors

Teti *et al*. (2015) found a negative relationship between corporate governance and the cost of equity capital, i.e., good corporate governance standards might decrease agency problems and improve the quality of a company's information flow, minimizing information asymmetry. Fonseca, Silveira & Hiratuka (2016) also found that the quality of financial and accounting statements, underlying transparency, reduced information asymmetry, positively impacting stakeholders' perception, as observed in a sample of 252 non-financial Brazilian companies publicly traded from 2000 to 2013. The previous authors confirmed that the corporate governance factor was relevant in determining the companies' capital structure, not only positively influencing the number, but also the quality of debt. Even though the previous results concern large companies, they corroborate this study's findings.

Therefore, there is evidence that corporate governance can regulate, monitor, and control the behavior of SME managers, possibly decreasing moral hazard in the use of capital and improving transparency and accountability to eliminate asymmetric information between banks and SMEs (Mutamimah, Tholib & Robiyanto, 2021).

Additionally, although not statistically significant, liquidity and board of directors were positively related to long-term debt. The variables negatively related to long-term debt, though not statistically significant, were seriousness and basic reports. These results indicate that small companies need to acquire a greater understanding and adopt governance practices.

The other model concerned the companies' total debt. Some variables were removed since they did not meet AVE and CR criteria (Basic reports - Acc - 9 and Seriousness - T-12). After adjustments, the model presented AVE>0.5 and CR>0.7 for all variables (Table 9), with factor loadings (in bold) greater than cross-loadings ("off-diagonal" loadings), which confirms discriminant validity.

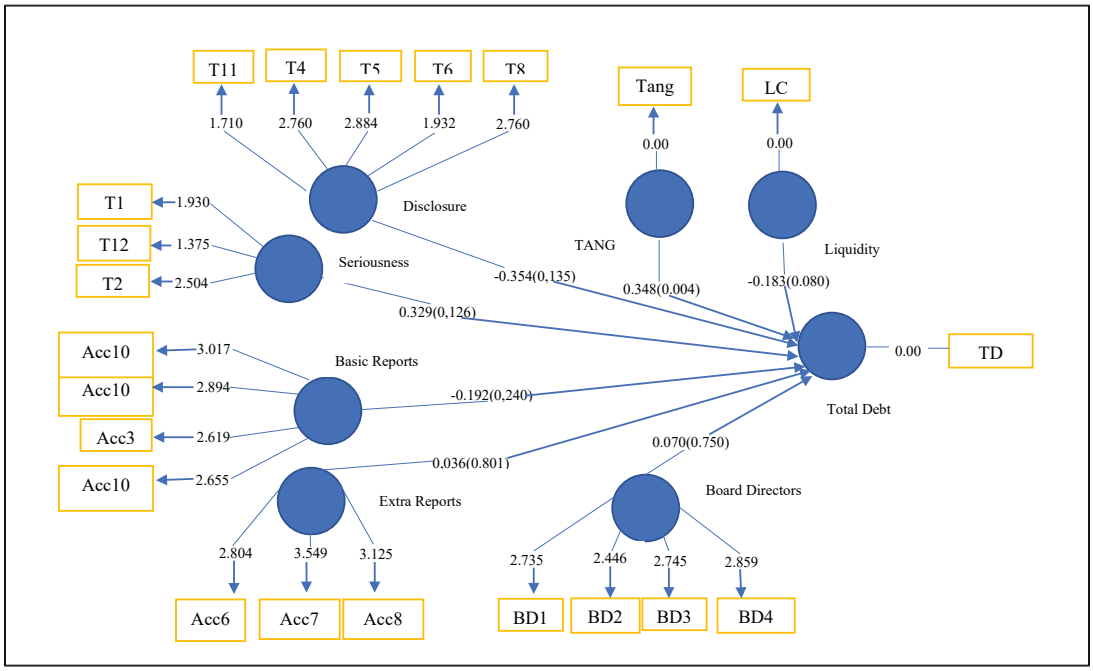
Table 9

Results of the model assumptions for the bank debt variable.

Latent variable	1	2	3	4	5	6	7	8
1. Board directors	**0,768**							
2. Bank debt	0,136	**1,000**						
3. Liquidity	-0,035	-0,175	**1,000**					
4. Basic reports	0,265	-0,176	0,098	**0,797**				
5. Extra reports	0,173	-0,074	-0,249	0,510	**0,879**			
6.T. Disclosure	0,176	-0,252	-0,003	0,381	0,350	**0,710**		
7. T. Seriousness	0,241	0,189	0,042	0,392	0,227	0,277	**0,715**	
8. TANG	0,264	0,285	0,072	0,007	-0,065	0,175	0,049	**1,000**
Cronbrach's alpha	0,844	1,000	1,000	0,848	0,854	0,845	0,834	1,000
Composite reliability	0,866	1,000	1,000	0,874	0,910	0,830	0,742	1,000
AVE	0,621	1,000	1,000	0,634	0,772	0,504	0,511	1,000

Note 1: the diagonal values are the square root of AVE.
Note 2: the three reliability measures were kept.

The structural model was also analyzed, and the results are presented in Figure 2. Tangibility was confirmed at a level of 5% ($p<0.05$), and liquidity was marginally significant ($p<0.10$). A medium effect size (f^2) was found for the seriousness variable (16%), a small effect size was found for tangibility (15%), and a medium explained variance was found (adjusted $R^2 = 24.1\%$).



Note: values outside parentheses are standardized structural coefficients (betas), and values inside parentheses are p-values.

Source: developed by the authors

Figure 2. Model for the Total Debt variable

The Beta value (0.348, p=0.004) for the level of asset tangibility suggests that the higher a company's number of assets, the higher its debt level, which is relevant for long-term debt as well. Therefore, this finding is in line with the Pecking Order theory; companies with guarantees make creditors feel more comfortable financing their investments, which decreases financial costs (Myers; Majluf, 1984).

The liquidity positive association (Beta value=-0.183; p=0.080) indicates that the higher a company's liquidity level, the higher its total debt level. Such a result contradicts the Pecking Order theory, considering that profitable companies with higher current liquidity would use internal resources to finance their investments. On the other hand, creditors value liquidity; hence, companies with a high current liquidity level can obtain higher levels of external debt, especially in the long term, being more capable of paying loans when they are due (Ozkan, 2001). Furthermore, companies with a high liquidity ratio could use the resources to finance the company's short-term activities.

Table 10 shows that the companies in the sample exceed the R$1.00 of current liquidity indicated in the literature; they presented an average current liquidity of 3.83.

Table 10
Current Liquidity Index

No. of respondents	Minimum	Maximum	Mean	Standard Deviation
102	0,23	19,00	3,83	4,472

Source: developed by the authors

Furthermore, 67.6% of the companies presented current liquidity between more than 1.00 and equal to or below 5.0, indicating that most companies present favorable liquidity levels. A percentage of 15.7% of the companies presented current liquidity between 5.00 and below 10.00. Another 11.8% of these had more than 10 times rights and assets compared to their liabilities. Only 4.9% of the respondents had a liquidity of less than 1.00, i.e., they could not pay their short-term debts with their short-term resources.

Additionally, the variables seriousness, extra reports, and board of directors, although not significant, were positively related to total debt.

Kumar and Rao (2016) verified the banks' resistance to granting credit to small businesses. The authors observed that small and medium-sized companies depended on short-term debt, as they had difficulties accessing long-term debt due to information asymmetry, credit rationing, and a lack of audited financial statements. Dependence on short-term debt possibly explains why no governance mechanism was significant in the total debt model, with tangible assets being "sufficient information to raise funds from third parties, especially short-term, which require a smaller amount of information due to lower risk.

The board of directors variable was not significant in the models, possibly because most small companies have a board of directors composed of a single person who is also the president and CEO (Compagno, Pittino & Visintin, 2005). Hence, the companies in the sample have only an informal family council or one person responsible for the company's most important decisions. Having decisions centered on a single individual leads to difficulties due to a failure to improve skills and a lack of knowledge regarding management instruments, expertise about the financing options, and strategies to obtain capital, which inhibit the growth of these companies (Jain & Gumpert, 1980; Abor & Adjasi, 2007); a notion confirmed by the level of education reported. Even though the number of managers who sought qualifications increased, more than half of these companies are under the management of individuals who lack academic specialization and/or technical experience.

Thus, the results indicate that governance mechanisms, especially providing quality and quantity of information, are relevant to attracting external resources. For this reason, small companies should adopt and deepen their understanding of governance mechanisms. However, as Al-Najjar and Al-Najjar (2017) note, SMEs in the United Kingdom are not as active as large companies in adhering to governance mechanisms, arguing that policymakers in the United Kingdom should propose rules and regulations to encourage MSEs to adopt such practices.

5. Final Considerations

This study aimed to identify how the governance mechanisms (disclosure, seriousness, basic reports, extra reports, and board of directors) adopted by the small and medium-sized companies in the clothing APL in Agreste, PE, Brazil influence fund-raising.

The results show evidence that the small and medium-sized companies composing the Agreste clothing APL adopt governance practices that influence their capital structure, which may facilitate obtaining debt from third parties, especially in the long term.

Transparency and accountability were statistically significant. Although these variables were relevant as potential determinants in attracting external resources, the small effect size indicates that the adoption of transparency and accountability practices is still incipient. The general means of 3.394 and 3.076, obtained by transparency and accountability, respectively, confirm the small and medium-sized companies' timid adoption of governance practices.

However, there has been progress in the adoption of governance practice despite it being a voluntary commitment. Obstacles emerge when a company attempts to introduce governance mechanisms. As decisions are traditionally centered on a single individual, managers are expected to focus on their companies' day-to-day matters and challenges to ensure business continuity instead of dealing with strategic issues such as governance.

This factor may explain why the board of directors was not relevant or significant in determining the small and medium-sized firms' capital structure. Having crucial decisions under the sole responsibility of the founder/manager leads to problems, as managers often fail to improve skills and lack knowledge regarding management instruments, which inhibit these companies' growth; hence, small businesses do not enjoy the benefits of a board of directors.

Understanding and implementing governance practices, even in the face of limitations, is essential for small businesses' sustainable development, as such practices are an opportunity to improve performance and ensure business continuity.

This study presents some limitations that indicate directions for future studies. The sample size stands out, as it may not satisfactorily represent the actual context of SMEs. Nevertheless, it is worth noting the difficulty in obtaining information from the companies in the sample due to the owners' resistance.

Future studies are suggested to address larger samples to portray the exact values of the financial accounts without using value ranges. Furthermore, longitudinal studies would enable the assessment of the current level of governance adoption and the verification of how it behaves over time, providing a better framework to examine the effectiveness of governance practices at the small business level.

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