Application of corporate governance measures in Indian small and medium enterprises: A way forward

Nandkishor N. Dhondge
Research Guide, Department of Commerce, B. S. Patil Mahavidyalaya, Paratwada, Achalpur Camp, Amaravati, Maharashtra, India

ABSTRACT

Purpose: The current review article provides a bird’s eye-view on corporate governance measures and its importance for the small and medium enterprises (SMEs) in India. In spite of its huge contribution to economic growth and employment generation, the role played by SMEs is often unrewarded and, in cases, remains unacknowledged. Although corporate governance measures have been introduced before 30 years, that is, after Cadbury report, its 100% compliance among the large-sized corporations in India remains opaque. Hence, the current review work is a first-of-its-kind attempt to provide more insights about this unexplored domain, with regard to Indian SMEs. Indian SMEs have huge potentials that are yet to be untapped and it is possible to leverage the workforce, resources, raw materials and government support through proper channelization. Methodology: The current review follows the exploratory research approach since the studies pertaining to corporate governance in Indian SMEs are negligible. To fulfill this research gap, the study attempts at covering the most important aspects of the domain. Findings: The review highlighted the importance of corporate governance and emphasized the need for its implementation among the Indian SMEs so that it can compete with its international counterparts. The review quoted examples of implementing corporate governance among the SMEs in various developing nations and also provided policy-level recommendations. Implications: To gain sufficient level of trust and confidence upon the SMEs’ financial performance by the investors, the current review suggested the possible measures to be undertaken by the government and the entrepreneurs since the contribution should be collaborative in true spirit. Future empirical studies should be conducted in this domain so as to provide suggestions for the policy-makers, entrepreneurs, investors, and so on. Originality: The current review article is a holistic paper that covered the aspects of corporate governance and detailed about the need for it case of Indian SMEs. Only a handful of studies focused on corporate governance in Indian SMEs so far which lacked to provide the way forward and the need for training, awareness, etc.,

Key words: Companies act, company board, corporate governance, performance, small and medium enterprises, sustainability

JEL Classification: G34, L3

*Corresponding author: Nandkishor N. Dhondge, Research Guide, B. S. Patil Mahavidyalaya, Paratwada, Achalpur Camp, Amaravati, Maharashtra, India. E-mail: nandudhondge22@gmail.com

Received: January 05, 2023; Revised: March 22, 2023; Accepted: May 26, 2023

DOI: 10.18843/ijcms/v14i2/02
INTRODUCTION

Good corporate governance translates to a scenario in which a company executes its businesses as per the law of the land in a legal, ethical, and transparent manner. The vibrant nature of the corporate governance must emerge from the top leaders of the organization and pass on to the entry level employees (Confederation of Indian Industry, 2009). It can also be simply mentioned as the guidelines and the methods, based on which the corporations are governed. Corporate governance helps in alleviating potential conflicts among the shareholders from various facets of life and the investors can gain more confidence and knowledge about the company’s functioning, its financial stability, performance and make the company, and accountable (Yousuf and Ariful, 2015). The primary role behind corporate governance is to ensure transparency and maximize the value of the shareholders so that their interests are safeguarded.

According to (Karmakar and Dutta, 2022), corporate governance has a primary purpose to achieve, that is, to ensure that the management is sensible, entrepreneurial, and efficient in nature so that the company has a long-term prevalence. After the Asian financial crisis that occurred in 1997, corporate governance has gained a momentum in the corporate world across the globe. The Cadbury committee report acted as a first-of-its-kind initiative to install corporate governance measures in the firms worldwide. The article authored by (Tiwary and Sahay, 2021) emphasized the importance of legal institutions in corporate governance and how it helps the creditors as well as minority shareholders. The study found that the investors tend to lose confidence to invest if the managerial agency problems go overhead in a country with weak legal systems to protect the investors’ interests.

On the other hand, the present study attempts to explore the applicability and impact of corporate governance measures on small and medium enterprises (SMEs) which act as the backbone of a nation’s economic growth and employment generation. In Indian setting, the contribution of SMEs toward the GDP and employment generation is huge. According to the Ministry of SME (MSME), Maharashtra has the higher number of Udyam Registrations as on May 2023, as shown in Figure 1.

During the pandemic, the union government supported the MSMEs through extended Emergency Credit Linked Guarantee Scheme (ECLGS) which, in turn, increased the credit growth (up to 30.5%) for the industry during January–November 2022. Further, the GST paid by the MSMEs also increased alike the pre-pandemic period which establishes their financial resilience (Ministry of Finance, 2023). In comparison with FY2022 (Until November 2021), the number of SMEs with IPOs got doubled and they also raised almost three times of the funds compared to the previous financial year (Press Information Bureau, 2023). In the aftermath of COVID-19 pandemic, the Indian MSME revenue is predicted to increase up to 1.36 times in fiscal 2024 than the pre-pandemic fiscal (2020) year (CRISIL, 2023).

In this background, the current review article is a first-of-its-kind attempt to emphasize the need for corporate governance in Indian SMEs. With the Indian government taking numerous measures to boost the growth and performance of SMEs, the employment opportunities, stock performance, exports, GDP growth, women empowerment, healthy banking industry, entrepreneurship, skill development, and poverty alleviation experienced an uplift compared to the previous years. To attract the investments, there is a need to instil trust among the inland and foreign investors about the performance of SMEs in a holistic manner. The Ideas from the Yale management (McLarty and O’Dowd, 2020) emphasized the need for a professional and independent board to look after the corporate governance matters in SMEs to achieve long-term success. Hence, the present study attempts at providing an overview and highlighting the importance of corporate governance, need for its implementation among the Indian SMEs, experience from the rest of the developing nations, policy-level recommendations, awareness, and training for the entrepreneurs and the way forward.

Figure 1: Top ten states in terms of Udyam registrations
Source: Ministry of Micro Small and Medium Enterprises, 2023
CORPORATE GOVERNANCE IN INDIA – AN OVERVIEW

According to PwC, corporate governance not only enhances the performance of a company but it also increases the trust of the shareholders. The report mentions eight components to be crucial in corporate governance, as shown in Figure 2. The 2013 Companies Act brought comprehensive reforms in almost all the areas that tend to influence the outcomes of corporate governance. The reforms included more duties for the directors, heavy requirements for individuals to become independent directors, and the introduction of shareholder class action suits (Yousuf and Ariful, 2015). Being an umbrella term, corporate governance details about the formal accountability system of the corporate directors to the owners of the companies (Kiranmai and Mishra, 2019).

The business ecosystem in India is moving toward Anglo-American model of corporate governance. There is a paradigm shift experienced in the corporate governance practices from the earlier shareholder-oriented system toward a dynamic stakeholder-centric system (Zhang et al., 2022). Post-economic liberalization, SEBI, has constituted various committees to develop the codes of conduct for good corporate governance. In 2003, the National Foundation for Corporate Governance (NFCG) was incorporated under the Ministry of Corporate Affairs, in partnership with Confederation of Indian Industry, Institute of Company Secretaries of India and Institute of Chartered Accountants of India (ICAI). The trustees’ list got expanded to Institute of Cost Accountants of India (ICAI) and National Stock Exchange in 2010 and Indian Institute of Corporate Affairs in the year 2013 (Ministry of corporate affairs, 2023).

The objective of this foundation is to promote good corporate governance practices at both industry as a whole and at individual corporates. The foundation also aims at bridging the gap between the corporate governance framework and the actual compliance by the corporates. The objectives of NFCG are corporate governance, corporate social responsibility (CSR), ethical business practice, sustainability, environmental, social and governance, risk management, and data governance and cyber security (National Foundation for Corporate Governance, 2022). According to the Companies act 2013, the independent directors are bound to report unethical behavior and fraudulent activities that harm the company’s code of conduct or ethics policy. Further, they are also bound to uphold the ethical standards of integrity and probity (Constitution of India, 2013).

THE PARADIGM SHIFT

The corporate governance practices were given prime importance in India only after the collapse of high-profile corporations in the period 2001–02 involving auditing, accounting corruptions and after the financial crisis in 2008–09 (Robin, 2019). In the post-liberalization era, with the nation being recognized as the world’s one of the largest markets and investment destinations, it has become important for the firms to gain trust among the investors. Despite the challenges faced in terms of board members’ selection, performance audits, accounting issues, extensive role played by the founders in case of family-owned businesses, transparency and conflicts, and corporate governance measures need to be incorporated and thoroughly adhered to (Baharul Islam, 2015; Robin, 2019; Surbhi, 2023). The role played by SEBI and clause 49 of the listing agreement in ensuring that the companies adhere to corporate governance practices have been studied extensively (Gupta, 2023). In the case study authored by (Lokanan, 2021), the corporate governance issues that led to the downfall of Satyam computer services limited, India was discussed in detail. The study analyzed the corporate governance structure and strategies of the firm and detailed about the problems and deficiencies that collapsed the organizational repute by following a structural functional approach.

**Figure 2:** Practical guide to corporate governance
Source: PwC (PwC, 2020)
In the study conducted by (Palaniappan, 2017), the researcher focused on a few CG issues such as size, duality, independence, and the activity of the boards and how far it impacts the performance of the firm. Based on the multiple regression model outcomes, the author found an inverse association between the performance indicators of the firms and the extent of board characteristics. In the literature (Karmakar and Dutta, 2022), it was reported that the organizational performance gets heavily influenced by the corporate governance mechanisms followed in the organization. This research work established the strong relationship that exists between the variables considered. It is not only for the corporations but also the corporate governance measures can be applied for the utilities of the governments as well. The study conducted by (Srivastava and Kathuria, 2020) found a positive relationship between CG index and utility performance. In the study conducted by (Kiranmai and Mishra, 2019), the authors compared different corporate governance variables (such as board size, meetings, committees, composition, independent directors, firm age, and gender diversity) of the listed State Owned Enterprises (SOEs). The study findings infer that the CG mechanisms tend to influence the performance of the commercial-listed Indian SOEs. The study recommended that an optimum number of directors brings in more human capital which, in turn, translates into the fact, increased firm performance.

In spite of the challenges encountered in huge-sized corporations and business conglomerates (Dwaikatt et al., 2020), various measures are taken continuously so that the corporate governance practices are adhered to. On the other hand, across the global nations, the corporate governance measures have been recommended for SMEs as well. The following section discusses the experience gained in other developing nations on the implementation of CG practices in SMEs and the outcomes achieved.

**EXPERIENCE FROM THE REST OF THE DEVELOPING COUNTRIES**

China, one of the most important economies in the world, only after US, has established a Growth Enterprises Market (GEM) board in 2009, alike the NASDAQ in the US, for increased access to external finance for the SMEs. This incorporation has heavily emphasized the importance of governance structure among the SMEs in China. Because the GEM demands the SMEs to have higher participation from the external investors compared to the insider ownership, thus enhancing long-term performance and external financing attributes (Huang et al., 2016). In India, BSE launched SME exchange platform for the first time in 2012 and made it investor-friendly. According to the researchers (Shapiro et al., 2015), corporate governance and ownership tend to have a strong positive influence on the innovation activity, which remains a key attribute for the growth and development of SMEs. Sustainability has become an important concept in the corporate governance policies of China while according to (Akomea-Frimpong et al., 2022; Aggarwal, 2022), climate change, digitization, and racial equality issues remained unaddressed in the context of Chinese SMEs.

In the research work conducted among the Brazilian SMEs (Latini et al., 2014), the authors found that the private equity and venture capital funds play a crucial role in the promotion of corporate governance practices among the SMEs. In the study conducted earlier (Oghuma and Garuba, 2021), the authors analyzed the influence of corporate governance on risk disclosures among the Nigerian deposit money banks and found its crucial role. The study recommended to have a strong corporate governance mechanism in place among the Nigerian banks. The performance of the firms gets heavily influenced by the corporate governance measures, according to Ali et al., 2022. In their study, the authors analyzed the quantitative data and found that firm performance and the overall extent of the directors, board independence, and average education of the board members have a positive association. Further, the results established that board size and member’s education significantly affect the performance of the firm. Although this has been a scenario in a few developing countries, there is a lack of in-depth studies focusing corporate governance among the SMEs (Zhang et al., 2022).

**NEED FOR CORPORATE GOVERNANCE IN SMEs**

In the study conducted earlier (Mehta et al., 2019), the authors emphasized the role played by SMEs toward the GDP, generation of employment opportunities, and so on. This study analyzed whether the presence of independent director on the board brings significant contribution to the profit of SMEs and found it significant only for two financial years of the study period. On the other hand, the profit of the SMEs got enhanced during the period of study. Hence, the study suggested to have regular, audited reports and disclosures to both domestic and foreign investors and install a secure system so as to safeguard the whistle-blowers. In the literature (Shubha, 2018), the influence of corporate governance on the financial performance of the select SMEs in Bangalore...
urban district was analyzed. The study concluded that governance rating, employee, and environment-related dimensions play a crucial role on the financial performance of the SMEs. The study recommended the SMEs to install a good governance system and achieve sustainable performance. In Dwaikatt et al., 2020, the authors recommended that if corporate governance measures are installed in SMEs, it can mitigate such issues since the external board members can bring in funds that are necessary for the development aspects. Further, the authors also mentioned that creativity, innovation capability, and appropriate auditing are fruitful results that can be achieved with the induction of corporate governance into the firms.

**AWARENESS AND TRAINING PROGRAMS ON CG AMONG THE SMES**

As per IFC (International Financial Corporation, 2019), the SMEs can attract investors if they use better governance as a core value. When it comes to SMEs, corporate governance remains a core feature in the value creation strategy that helps them in survival, growth, and gain an edge than their competitors. The corporate governance methodology followed by the International Finance Corporation for the SMEs involves five aspects, as shown in Figure 3. The authors (Ryabota et al., 2019) have segregated the stages of SME growth as start-up, active growth, organizational development, and business expansion. The IFC corporate governance framework, shown in Figure 3, is based on the OECD Corporate Governance Principles. According to OECD, “Good corporate governance is not an end in itself. It is a means to create market confidence and business integrity, which in turn is essential for companies that need access to equity capital for long term investment” (OECD, 2016).

**POLICY-LEVEL RECOMMENDATIONS**

Sustainable development is a desirable achievement that needs to be contributed by both the SMEs as well as the stakeholders (Zhang et al., 2022). Hence, the corporate governance policies should bring in sustainable performance as a mandatory criterion to be achieved. The implementation of corporate governance in SMEs has its own issues such as additional auditing rules, extra candidacy into the board, increased operational costs, and so on. In the multi-theoretical approach study conducted earlier (Edacherian et al., 2023), the authors found that the board committee interlock is negatively correlated to firm performance. Hence, instead of assigning specific tasks that requires intensive monitoring, the directors should be given independence so that they focus on the outcomes of the audit, instead of doing it by themselves. The authors (Ezhilarasi and Kabra, 2017) investigated the extent of influence by the corporate governance measures on disclosure of the environmental information by the companies. This study considered board size, CEO duality followed by domestic and foreign institutional ownership. The research inferred that foreign institutional ownership remains the most crucial CG measure to have an impact on environmental information disclosure. Further, the company size and environmental certification too influence the variable considered. Hence, these elements must be focused before the incorporation of corporate governance measures in the SMEs. According to Merino et al., 2015, when the family members are involved in the operations of the company, then it becomes detrimental for its growth and even existence too. Hence, it is must for the SMEs to have an informal and formal governance mechanisms in place to ensure innovation and continued enhancement. In line with Handley and Molloy, 2022, the optimal size of boards, defined role for the board members and multiple other factors can help to reduce the conflict of interest, increase the innovative nature, streamline the financial health of the company, generate trust and opportunities for growth, bring diversity, ensure funds inflow, skills development, and so on.
CONCLUSION AND THE WAY FORWARD

The current review article is an attempt at analyzing the challenges involved in the implementation of corporate governance among the SMEs, though the large-sized companies themselves are already facing the brunt of the non-adherence. In spite of the fact that the Indian laws regarding corporate governance are one of the best globally, its adherence is still under question. After the exposure of multiple scams, the trust on the business ecosystem in India and its financial stability has shaken for a while. However, the need of the hour is to install trust and confidence among the investors on SMEs since its true potentials remain untapped. The present study provides an overview of the corporate governance in India and her counterparts in the Asian region and other countries. The need for corporate governance and the policy-level recommendations was made in this review article. Future research works must be conducted with inputs from the policy-makers, entrepreneurs, investors, venture capitalists, market regulators, bankers, and the common public about mandatory compliance to CG measures in Indian SMEs so that the latter’s contribution to economy is not only acknowledged, but also rewarded with recognition and provided opportunity to compete with their global counterparts. After COVID-19, the growth of Indian SMEs has touched the pre-pandemic levels in 2022–23 financial year and is predicted to cross this threshold as well. However, to ensure that the growth does not retaliate, it is the need of the hour to ensure the corporate governance practices are in place among the Indian SMEs. In spite of the initial shortcomings, this would be a game-changer for the growth and development of the SMEs and in turn, the nation.

AUTHOR’S CONTRIBUTION

As the sole author of this review article, I have made significant contributions to every aspect of the study. From topic selection and literature review to data analysis, writing, and overall supervision, my efforts and expertise have been integral to the completion of this review article.

FINANCIAL SUPPORT

There is no financial support received for the completion of this review article.

ACKNOWLEDGMENT

I would like to express my gratitude for the support and guidance provided by my mentors, colleagues, and reviewers throughout the completion of this review article.

CONFLICTS OF INTEREST

This is to bring to your kind consideration that this research work has no conflicts of interest.

REFERENCES


Edacherian, S., Richter, A., Karn, A., & Gopalakrishnan, B. (2023). Connecting the right knots: The impact of board committee interlocks on the performance of...


Gupta, S. (2023). *SEBI as a Gatekeeper of Corporate Governance in India.*


