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ABOUT US

WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

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THE IMPACT OF CORPORATE GOVERNANCE ON THE MANAGEMENT OF SMALL AND MEDIUM ENTERPRISES

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"Corporate governance is not a matter or right or wrong-'it is more nuanced than that."
-Advocate Johan Myburgh

Abstract

By offering an in-depth knowledge and insight into the role that corporate governance can play in promoting the growth and development of small and medium-sized enterprise. This conceptual paper aims to further the development of the small and medium-sized enterprise (SME) governance literature streams. Due to its significance for the future of businesses, corporate governance is a topic that is receiving a lot of attention worldwide. More importantly, the global business stakeholders are highly concerned about how businesses are governed to achieve a balance of economic, social, and environmental values in light of the worsening environmental and social issues.

The success of many large organizations has been linked to good corporate governance. It has been praised as one potent tool that brought about the sustainability of these organizations in this competitive era, from the boardroom to the triple bottom line. Large organizations can benefit from this, but small and medium-sized businesses (SMEs) can also add value to their businesses by drawing from these experiences. In the long run, this can open up new markets and lead to innovative business practices that SMEs can use in their day-to-day operations.

Modern corporate governance is situated at the complex intersection of economic efficiency, legality,

and morality. Governance problems arise when a corporate entity acquires independence and ownership of the company is separated from management.

Keywords – Corporate Governance, Small and Medium Class Enterprises.

Introduction

The systems and procedures that govern how businesses are run are known as corporate governance. Effective corporate governance reduces risk, facilitates capital access, increases operational efficiency, and guards against mismanagement. It equips businesses with the means to address stakeholder concerns and increases their transparency and accountability to investors. Corporate governance also promotes development by assisting in the creation of new investment, capital access, and long-term firm sustainability, all of which promote economic expansion and more job opportunities in all markets.

SMEs can use a critical set of tools provided by governance to support their competitive growth and survival. Entrepreneurs must begin running their businesses on a set of guiding principles, believing that particular solutions and resources will change as their business expands. For instance, when implemented correctly, even basic internal controls can aid in the prevention of fraud and enable more precise financial reporting and planning. These tools do not force business owners to adopt standard "best practices." Rather, entrepreneurs acquire the skillset to recognize governance deficiencies within their own enterprises and devise pragmatic remedies that will augment their enterprise and foster its enduring expansion.

Corporate governance's primary goal is to manage the business effectively so that strategic decisions can be made. Additionally, it guarantees accountability, transparency, and the protection of stakeholders' interests.[1]

[1] Introduction of Corporate Governance, *available at* : https://www.ifc.org/content/dam/ifc/doc/mgrt-pub/cg-smes-fact-sheet- may2019.pdf (Visited on November 25,2023)

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Definition of Corporate Governance

Definition of corporate governance by the Indian Institute of Company Secretaries of India is as under:

"Corporate Governance is the application of best management practices. Compliance of law in true letter and spirit and adherence to ethical standards for Effective Management and distribution of wealth discharge of Social Responsibility for sustainable development of all stakeholders."

Definition of corporate governance by International Chamber of Commerce is as under:

"Corporate Governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations."[2]

Organisation for Economic Co-operation and Development (OECD), 2022 has defined corporate governance as such:

"Good corporate governance helps to build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies."[3]

The Cadbury Committee (U.K), 1992 has defined corporate governance as such:

"Corporate Governance is the system by which companies are directed and controlled. It encompasses the entire mechanics of the functioning of a company and attempts to put in place a system of checks and balances between the shareholders, directors, employees, auditor and the management."[4]

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[2] Definition of Corporate Governance by International Chamber of Commerce, *available at* : https://www.corpgov.net/library/corporate-governance-defined/ (Visited on November 25,2023)

[3] Ibid.

[4] Suratha Kumar Das and Chitta Ranjan Mishra,Corporate Governance 5 (Vikas Publishing House Pvt Ltd., New Delhi, 2020)

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Components of Corporate Governance

Board of Directors is an organization's governing body. It is in charge of managing personnel, establishing strategic goals, and making important choices. Additionally, it guarantees that the business is operating to best serve stakeholders. Owners of the company are known as shareholders. They vote to choose the Board of Directors and are endowed with certain duties and rights. The process of organizing, staffing, directing, and controlling in order to achieve a desired outcome with the least amount of money and resources is known as management. The Company shall obtain a certificate from the auditors of the company regarding the compliance of conditions of corporate governance. This certificate shall be annexed with the Director's Report sent to shareholders and also sent to the stock exchange.[5]

Principles of Corporate Governance and Relevance

- Transparency: - It is the ability to give shareholders and other stakeholders fast, accurate, and understandable information about a company's financial performance, risks, strategies, and governance procedures.
- Accountability: - It is the duty of an individual to provide an explanation of the outcomes of any decision they make that will benefit other people. In the context of corporate governance, the Board of Directors is liable for accountability as they are the decision-makers.
- Independence: - Strong, impartial, and able to make decisions based on business needs, the governing body is a necessary component of good corporate governance.[6]

  Corporate Governance is highly relevant to Small and Medium Size Enterprises (SME's) as it provides a framework for the way a company is directed and controlled. While often associated with larger corporations, the principles of good corporate governance are equally important for SME's.
- Enhanced Trust and Credibility: - SME trust and credibility can be improved by implementing good governance practices in the eyes of stakeholders, including lenders, suppliers, investors, and consumers. Trust can be increased and more business opportunities can arise by

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[5] Components of Corporate Governance, *available at* : https://schoolofpoliticalscience.com/elements-of-corporate-governance/ (Visited on November 23,2023)

[6] Principles of Corporate Governance, *available at* : https://www.investopedia.com/terms/c/corporategovernance.asp (Visited on November 23,2023)

upholding honest and moral business practices.

- Access to capital:- Small and medium-sized enterprise (SME) possessing robust corporate governance can enjoy advantageous business prospects, as investors are inclined to extend their support to such enterprises.
- Risk management: - SME's can identify and lower risks with the aid of corporate governance mechanisms. It makes it possible for them to overcome obstacles more quickly.
- Extended-duration sustainability: - Good decision-making and accountability help SMEs become more sustainable. In the long run, it keeps SME competitive and helps them overcome obstacles more effectively.
- Enhanced Results: - SME's can expand more quickly, profitably, and efficiently with the support of sound governance.

Even though they might not have as many resources as larger companies, SME's still have a lot to gain from corporate governance. These SMEs can increase productivity and profitability by adopting a culture of good governance.

Although SME's might not have enough resources as compared to larger one, corporate governance is highly relevant for these enterprises. By adapting the culture of good governance, these SME's can improve their work efficiency and profitability.

Issues in Corporate Governance

There are several issues in corporate governance and they all are interconnected. They have different priorities in each of the corporate bodies. These are as under:-

- Value based corporate culture: - It is important for an organization to work in an efficient manner by following certain ethics, values and principles of business which cannot be ignored. Therefore, it is necessary for an organization to follow a value based corporate culture to maintain a long run business.
- Holistic view: - This is a business strategy that forces all departments within an organization to collaborate in order to accomplish a common objective. It does, however, call for extra

work, but once implemented in an organization, growth will happen more quickly.

- Compliance with laws: - Businesses that prioritize development, uphold high ethical standards, and must operate sustainably adhere to laws such as those set forth by the Securities Exchange Board of India (SEBI), the Foreign Exchange Regulation Act, the Competition Act of 2002, cyber laws, banking laws, etc.
- Disclosure, transparency, and accountability: - Providing clear, accurate, and timely information to shareholders and stakeholders about the company's financial performance and governance practices etc. for a long run business.
- Corporate Governance and Human Resource Management: - Corporate governance and Human Resource Management are connected with each other. Every employee should be treated with respect and appraisal should be given to those who deserve as well as motivation is required for those who are not capable enough.
- Innovation:-Innovation is an important factor which plays a great role in the progress of an enterprise. It is necessary to take risk of innovation for the survival in market. Every corporate body needs to innovate their product or service.
- Lessons from Corporate Failure: Every success has a lesson to be learned, just as every story has a lesson to be learned. Corporate entities also have policies that, should they fail, require learning from failure can come from both external and internal sources, but in order to practice good governance, corporate entities must move on from their setbacks and learn from them.
- Review of the Risk Management Framework: The Board makes sure that the business has a solid risk management framework which is reviewed and updated timely.[7]

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Legislative Framework of Corporate Governance

- Confederation of Indian Industry Code of Desirable Corporate Governance (1998)

In April 1998, the Confederation of Indian Industry framed a voluntary code of corporate governance which summarized a series of recommendations regarding best practices of corporate governance for listed companies. The main recommendations are as follows:

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[7] Issues in Corporate Governance, *available at* : https://www.legalserviceindia.com/legal/article-7450-issues-and-challenges- of-corporate-governance-in-india.html (Visited on November 25,2023)

Any listed company with a turnover of Rs 1000 million and above should have professionally competent and acclaimed non-executive directors. No single person should hold directorship in more than 10 listed companies. The full board should meet a minimum of six times a year, preferably at an interval of two months, and each meeting should have agenda items that require at least half-a-days discussion. As a general rule, one should not re-appoint any non-executive director who has not had the time to attend even one-half of the meetings. Various key information must be reported to, and placed before the board such as annual budgets, quarterly results, internal audit reports, show cause etc.

Listed companies with a turnover of Rs.1000 million or a paid up capital of Rs.200 million, whichever is less, should set up audit committees within 2 years. The audit committees should periodically interact with statutory auditors and internal auditors to ascertain the quality and veracity of the company's accounts as well as the capability of the auditors themselves.

- Kumar Mangalam Birla Committee (2000)

In the year 2000, Security and Exchange Board of India (SEBI) had set up a committee under Shri kumar Mangalam Birla, member of SEBI to enhance the standard of good corporate governance. Most of the recommendations of this committee were accepted and included by SEBI in its new Clause 49 of the Listing Agreement in 2000. The main recommendations of this committee were:

The Board of a company should have an optimum combination of executive and non-executive directors with not less than 50% of the Board comprising the non-executive directors. In case, a company has a non-executive chairman, at least one-third of board should be comprised of independent directors and in case, a company has an executive chairman, at least half of the board should be independent.

Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transaction with the company, its promoters, management or subsidiaries, which in the judgement of the board may affect their independence of judgement.

A director should not be a member in more than ten committees or act as chairman of more than five

committees across all companies in which he is a director. It should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

- Naresh Chandra Committee (2002)

The next step is the creation of the "Department of Company Affairs" (DCA) committee, which is led by Shri Naresh Chandra and is named "Naresh Chandra" Committee on August 21, 2002, to look into a number of corporate governance-related topics, such as the relationship between the company and the statutory auditor, the rotation of the statutory audit firm or partners, the appointment of auditors and setting the audit fees, the independence of the auditing functions, management's certification of the financial statements and accounts, the role of independent directors, etc. A number of the report's recommendations were included in the Companies (Amendment) Bill 2003, which is presently being examined.

- N.R. Narayan Murthy Committee (2003)

- Subsequently, "SEBI" established the "Narayana Murthy Committee," which was chaired by N.R. Narayana Murthy and comprised 23 members, including representatives from industry, investor associations, stock exchanges, and professional bodies, to examine how listed companies were implementing the corporate governance code. Numerous suggestions put forth by this committee have been incorporated into the updated Clause 49 of the Listing Agreement. The Narayana Murthy Committee made an effort to establish a successful corporate governance framework. The Committee's last report was turned in on February 8, 2003.

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The Committee observed that "Corporate governance is beyond the realm of law. It is a product of management culture and mentality and cannot be controlled by law on its own. The practice of managing a company's operations to ensure that it treats all of its stakeholders fairly and that its decisions benefit the largest number of stakeholders is known as corporate governance. It has to do with responsibility, honesty, and transparency. The purpose of legislation is to establish a common framework, or the "form," that will guarantee standards. The "substance" will ultimately decide the process's legitimacy and honesty. There is a connection between substance and management ethics

and mindset."[8]

Judicial Aspects

- Saurashtra Cement Ltd. v. Union of India

In accordance with its ruling in special Civil Application No. 6226 of 1994, the Gujarat High Court dismissed a number of writ petitions. The decision was made on June 22, 1994. Although the court vacated the interim orders, it did not issue an order pertaining to the payment of interest when it dismissed the writ applications. However, in Special Civil Application No. 6226/94, the court explicitly mandated the payment of interest at the rate of 18% annually in addition to vacating the interim order and discharging the rule. The High Court ordered the payment of interest at the rate of 18% after a request for clarification was filed in that particular group of writ petitions, where no order regarding the payment of interest has been made.

The Madhya Pradesh High Court's ruling serves as the basis for both the Special Leave Petition and these Civil Appeals. The High Court adhered to the previous ruling in the Mahalaxmi's case. The Supreme upheld the aforementioned Mahalaxmi ruling in 1995 (Supp.) 1 S.C.C 642. As a result, both the Special Leave petition and these appeals are denied.[9]

- Judhah v. Rampada Gupta

In this case, the Court determined that individuals duly appointed by the company to oversee and manage the business of the company are the directors of a company registered under the Companies Act. A director may also be referred to as a managing partner, trustee, agent, etc. However, each of these statements is meant to serve as a helpful point of view from which they may be taken into consideration at that specific time and place, rather than as an exhaustive list of their duties and powers.[10]

- Vodafone International Holdings v. Union of India

The Supreme Court of India rendered the historic decision in the case of Vodafone International

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[8] Ravi.B and S.K.Patil, "Corporate Governance in India- Evolution and Challenges", 5(3) IJCRT, pp. 237-239 (2017)
[9] Saurashtra Cement Ltd. v. Union of India, (2007) 2 GLR 1384, 2007 75 SCL 375 Guj.
[10] Judhah v. Rampada Gupta, AIR 1956 Cal.

Holding (VIH) v. Union of India (UOI). The Bench, which was made up of Chief Justice S.H. Kapadia, K. S. Radha Krishnan, and Swatanter Kumar, quashed the High Court's order of claim for Rs.12000 crores in capital gain tax and released VIH from paying the required amount (since it was a non-resident company for tax purposes) in the transaction between VIH and Hutchinson Telecommunication International Limited, or HTIL, on June 11, 2007.The court ruled that where a non-resident company is bought in a transaction to gain control over an interest in a (Indian) resident, the Indian revenue authorities lack the jurisdiction to tax an offshore transaction between two non-resident companies.

Since the sale of HTIL's CGP shares to Vodafone or VIH does not result in the transfer of capital assets as defined by Section 2(14) of the Income Tax Act, no capital gains tax will be applied to any rights and entitlements arising from the shareholder agreement or other agreements that are fundamental to the CGP shares. The High Court's order to demand nearly Rs.12000 crores in capital gains tax is quashed because it lacks legal authority and would effectively impose capital punishment for capital investment.

In a historic ruling, the Supreme Court clarified the uncertainty surrounding the imposition of taxes. Finally, it can be concluded that this ruling simplified the process of imposing taxes, acknowledged that the idea that a transaction's goal is to evade taxes does not always imply tax evasion, and supported the Supreme Court's interpretation of a lawful tax.[11]

- Bank of Poona v. Narayan Das

In this case court held that a director of the company is expected to work in the best interests of the organization to advance objectives that are advantageous to all of its members. The director must make decisions in good faith and ensure that the company benefits from all of their efforts.[12]

[11] Vodafone International Holdings v. Union of India, (2012) 1 S.C.R 573
[12] Bank of Baroda Ltd. v. Narayan Das, AIR 1961 Bom 252

Conclusion

In the end, we conclude that efficient and focused corporate governance help SME's to identify and manage potential risk. Good corporate governance practices promote the growth of SME's and also help to enhance the performance of the companies. It also provides sustainability to the firms and enables them to survive for long time in the competitive market.

By adopting corporate governance, a firm can make strategic decision and can generate extra return for shareholders. Effective corporate governance practices play an important role in risk mitigating and enable firms to face new market challenges. So, overall performance of firm can be improved by good corporate governance.

It offers a monitoring framework for achieving the company's goals. Investor confidence is increased by best governance practices, which raises the firm's value. There are metrics for corporate governance that are specific to listed companies and that are not generally accepted for use by small and medium-sized businesses.