CORPORATE GOVERNANCE ON MANAGEMENT OF SMALL MEDIUM ENTERPRISE

Saloni Das, , Law student, Symbiosis law school, Hyderabad, Symbiosis International (Deemed University), Pune, India & Dr. Anita Sable, , Assistant Professor, Symbiosis law school, Hyderabad, Symbiosis International (Deemed University), Pune, India

ABSTRACT

Corporate governance encourages the corporate entrepreneurship and competitiveness in businesses while also bringing fresh strategic perspectives through external independent directors. There are issues with managerial incompetence and credit constraints in the SME (Small Medium Enterprises) sector that may be resolved with a strong corporate governance system in place. Corporate governance has typically been linked to larger businesses and the presence of the organisation problem. Agency issues result from interactions between shareholders and managers. It happens, when there are conflicts of interest between organisation members and the business. The division between firm proprietorship and control is mostly to blame for this. It is simple to assume that SMEs are exempt from corporate governance because agency concerns are less likely to harm them. In SMEs, the owner usually functions as both the manager and the single proprietor. SMEs generally have a less clear division between ownership and management than larger corporations. Since they don't clearly distinguish between ownership and control, employ few people, and many of them are linked to the owner, some people contend that SMEs don't require corporate governance. Additionally, since SMEs are not dependent on public money, the issue of their accountability to the general public is non-existent. Most companies are immune from any disclosure obligations, notably sole proprietorships. The members' shared goals are to maximise profits, increase net market value, and reduce costs because there is no agency conflict. Members also ignore decisions made by the organisation that will lead to conflict. They do not need any incentives to motivate them because they receive direct payment. Despite these defences, it is widely believed that SMEs should not be subject to corporate governance.

It is crucial to examine corporate governance in the context of an emerging economy in the SME sector. The significance of sound corporate governance in the SME sector and the results of applying corporate governance principles to SMEs are conceptually examined in this article. The main motive of this article is to determine how SMEs might use the corporate governance framework.

Keywords: Corporate governance, Small Medium Enterprises (SMEs), Corporate Entrepreneurship, Independent Directors, Sole proprietorships

INTRODUCTION

A crucial element of our value generation strategy is corporate governance. Small and medium-sized businesses (SMEs) can employ the essential resources it offers to help their competitive survival and expansion. Entrepreneurs must begin running their businesses according to a set of guiding principles and have faith that tools and solutions will change as their businesses expand.

The implementation of corporate governance will necessitate the hiring of new and more directors, as well as extra roles in the audit, compensation, and nominating committees. Due to the active responsibilities, they will be performing, the non-executive directors will also need to receive increased compensation. As a result, the incorporation of corporate governance into SMEs' operations may result in greater start-up expenses, which may discourage people from starting their own businesses. By introducing subsidies for SMEs, the government can find a solution to this issue. At this point, it is crucial to elaborate on the previously mentioned topic of stakeholder theory and corporate governance.[1]

RELEVANCY OF THE TOPIC

Through external independent directors, corporate governance creates new strategic perspectives and boosts the corporate entrepreneurship and competitiveness of businesses. If the rules of corporate governance are correctly followed, there is no danger to value development in entrepreneurial enterprises.[2] Therefore, it is crucial to set explicit requirements for companies to create value. By ensuring that the interests of the companies are served, boards of directors in SMEs are likely to exert the much-needed pressure for greater performance. In the case of a SME, board members contribute expertise and knowledge about financing choices and tactics to source such finances to the company, addressing the credit constraint that SMEs face as well.

RESREACH OBEJCTIVES

The researcher lists out the following objectives in this paper:

- To understand the concept and working of Small Medium Enterprises

[1] MG Kellen, Role of small medium enterprises in economic development, pg 171, Article 5th April, 2017, https://www.emerald.com/insight/content/doi/10.1108/14720700710739769/full/html accessed 13th Nov
[2] ibid

- Examination of corporate governance in developing economy in the SMEs sectors
- What is the transition of a small medium enterprise to a large company
- How proper corporate governance benefits the management of SMEs

RESEARCH METHODOLOGY

The researcher has chosen "doctrinal methodology" in this research paper regarding

"Corporate Governance on Management of Small Medium Enterprises." Various sources are taken here to analyse more regarding this aspect.

Using the primary sources like statues of the relevant sections and secondary sources likes articles, papers, and books

LITERATURE REVIEW

As per the **UN Economic Commission for Europe**, these are the points to have a proper corporate governance in the sector of SMEs[3]:

- Good governance is an important element for economic growth
- Good governance in SMEs is equal to successful business which contribute to the overall economic growth.
- Particularly significant in developing countries with high unemployment rates.
- SMEs create job and support large base of stakeholders

As per **Hart, O. (1995) Corporate Governance: Some Theory and Implications. The Economic Journal:** Corporate governance is mostly caused by the division between company ownership and control. SMEs frequently consist just of the owner, who serves as both manager and sole proprietor. In general, SMEs typically have a less distinct split between ownership and management than bigger companies. Some claim that SMEs do not require corporate governance because they employ few people, many of whom are related to the owner, and there is no separation of ownership and control. Additionally, since SMEs are not dependent on public monies, the issue of their accountability to the general public is non-existent. Most

[3] The United Nations Economic Commission for Europe (UNECE) was set up in 1947 by ECOSOC.

businesses, especially sole proprietorships, are exempt from any disclosure requirements.[4]

Heath and Norman in his book **“Stakeholder Theory, Corporate Governance: What can the History of State-Run Enterprises Teach us in the post-Enron era”**: Explain why shareholders should be given priority in corporate governance matters because they are a major source of cash and finance for the company.[5]

Friedman in his book **“The Social Responsibility of Business Is to Increase Its Profits”:** Explains the maximisation of profit is the business's "social obligation." Or, to put it another way, "the business of business is business." We do not in any way claim that the stakeholder theory is unnecessary for corporate governance, but it is important to balance the various factors more effectively.[6]

SMALL AND MEDIUM ENTERPRISES

A small firm or the small medium enterprises is one that has a relatively small share of its market. An essential characteristic of small firm is that it is managed by its owners or part owners in a personalized way and not through the medium of a formalized management structure. It is also independent in the sense that it doesn’t form part of a larger enterprise and that the owner managers should be free from outside in taking their principal decisions.[7]

It serves as Industrial Development's skeleton. Nearly 8% of the GDP is contributed by the Ministry of Micro, Small, and Medium Enterprises, which also accounts for 40% of industrial production and 45% of exports.

It provides largest share of employment after agriculture. It emerged as a dynamic sector of economy. Nurtured for entrepreneurship and innovation. It is widely dispersed across the country and produces a diverse range of products and services.

EMERGENCE OF SME

[4] Hart, O. (1995) Corporate Governance: Some Theory and Implications. The Economic Journal, 105, 678-698. http://dx.doi.org/10.2307/2235027 accessed on 12th Nov 2022

[5] Heath and Norman (2004) Stakeholder Theory, Corporate Governance: What can the History of State-Run Enterprises Teach us in the post-Enron era? researchgate.net/publication/226752868_Stakeholder_Theory_Corporate_Governance_and_Public_Management_What_can_the_History_of_State-Run_Enterprises_Teach_us_in_the_Post-Enron_era accessed on 23rd Nov 2022

[6] Friedman (1970) The Social Responsibility of Business Is to Increase Its Profits

[7] Ministry of micro, small and medium enterprises

It is based on the Gandhi Model and supported by the MSME Act of 2006. Prior to 1991, India approved an industrial policy resolution in 1948 that outlines the role of the state in the development of industry. giving small and medium-sized businesses top attention with the implementation of Industrial Policy in 1991, the small-scale sector's scenario changed.

MAIN CHARACTERISTICS OF SMALL MEDIUM ENTERPRISES

- Independent entity, managed solely by owners
- The owner or a small group of owners give funding and capital.
- The company is often local, and local or national business operations are conducted.
- The company's staff members reside in the area.
- The size of the business will be smaller in industrial markets compared to larger organization
- Size of business is measured in terms of sales volume, profit, growth. No of employees' core competences, resources and capabilities.

BENEFITS AND CHALLENGES OF SMEs

Management structure

- Small business lacks management structure, control remains with owner or small group of people.
- Limiting control can reduce friction, help a company make wise judgments, and keep meetings and procedures to a minimum in a vast management hierarchy.
- One cannot be skilled for everything in the company. So, in the time of decision making, he may make the correct decision.

Learning Opportunities

- Most small business entrepreneurs gain their skills and knowledge through on-the-job training and self-employment.
- Although business owners may have extensive understanding in their industry, they lack an outside perspective on the company, thus more employees are required to bring in fresh talent and experience.

Informal Systems and Procedures

- Because of many small businesses are run by a single person or a select group of people, formal procedures are rarely in place.
- The organisation gains from this since everything is concentrated on a single commercial objective.
- When a company has rapid expansion, formal procedures often need to be put in place, which makes it challenging for management and staff to apply control because of the casual culture.

Investments

- The owners' personal savings are sometimes used to make capital investments in the company.
- Investments can sometimes be resisted, and expenses are kept to a minimum.
- Has a propensity to place more emphasis on short-term results than long-term planning.

CORPORATE GOVERNANCE

"The system by which companies are directed and controlled in the company. Boards of directors are responsible for the governance of their companies. The shareholders roles in governance are to appoint the directors and auditors and to satisfy themselves that an appropriate governance structure is in place". So, it completely depends upon the proper corporate governance of the company how good it performs in the market or in the unexceptional circumstances.[8]

DANGERS OF POOR CORPORATE GOVERNANCE

Every company's growth is determined by its proper mechanism of its corporate governance. Even in small medium enterprises for its proper growth it is important to have a proper management of corporate governance. Factors which lead to have a disastrous consequence in the profit-making organizations like SMEs are:[9]

Poor Strategy

[8] Definition of corporate governance by EBC Publication, 2008
[9] Risks of poor corporate governance – study iq article, 2019

Just as important as in a large company, smaller companies more agile and can adapt to changing circumstances. But have less resources (Limited funding) and more risk. More risk adverse: more dependent on resources, loss of a key resources could cripple business.

Disputes between owners

Engagement is less regulated. Shareholders agreements usually required. Reliance on the powers of the board into Management of Technology. Need for clarity on roles and responsibilities of directors (Distinct from their powers as shareholders) Use of non-legal routes for settling disputes e.g., ADR/ Mediation etc

Lack of success to capital

- Limited access to capital with high interest rates (risks) in personal assets pledged as security.
- Small balance sheet (low net asset value)
- Pressured cash flows (not much saving)
- Complete and accurate financial reporting can be difficult to maintain (limited skill, reliance on director or shareholders)
- Audited rather than receive financial information is equals to preferrable (provides more reliability)
- Appointment of NEDs can assist in ensuring oversight of financial reporting and risk management

Lack of management skills

- Objectively determining whether the management skill is available and actually deliver a strategy (role of board)
- Strengths and weakness of management's ability to address risks in the business (limited access to risks)
- Successions planning / key person risk (everything is vested in one or a few directors / shareholders)
- Key person dominance / not offset by larger board management team (father rules the business)
- Limited independence (no or few NEDs limited ability to influence the decision)

Perceptions of family business (nepotism)

- Aspirations to continue the business through generations
- May appoint less qualified or experienced family members to senior's positions ahead of other staff
- Remuneration level or benefits may be skewed in favour of family members
- Perception that limited growth for professionals is equals to poor staff retention (glass ceiling for anyone who is not family)

Informal internal financial controls

- Limited adherence to recommendations on financial controls (limited independent oversight)
- Breaching Companies Act IRO distributions to shareholders (w/o solvency and liquidity test and board approval)
- Company resources (e.g., Credit cards) being utilized for personal business
- Limited management oversight / authority to challenges or improve financial controls (no or few NEDs)
- Failure to appreciate the importance of external stakeholders
- Conflicted relationships with suppliers and customers (anti – competitive behaviours)
- Risk in becoming overdependent on key suppliers and customers

Corporate governance and SMEs

Traditionally, corporate governance has been associated with larger companies and the existence of the agency problem. Agency problem arises as a result of the relationships between shareholders and managers. It comes about when members of an organisation have conflicts of interest within the firm. This is mainly due to the separation between ownership and control of the firm.

It is tempting to believe that corporate governance would not apply to SMEs since the agency problems are less likely to exist. In many instances, SMEs are made up of only the owner who is the sole proprietor and manager (Hart, 1995). Basically, SMEs tend to have a less pronounced separation of ownership and management than larger firms.

Some argue that because SMEs have few employees who are mostly relatives of the owner and thus no separation of ownership and control, there is no need for corporate governance in their operations. Also, the question of accountability by SMEs to the public is non-existent since they do not depend on public funds. Most, especially the sole proprietorship businesses do not necessarily need to comply with any disclosure. Because there is no agency problem, profit maximisation, increasing net market value and minimizing cost are the common aims of the members. Members also disregard outcomes of organisational activities that will cause disagreement. They are rewarded directly and as such need no incentives to motivate them.

Thus disagreement does not exist and hence no need for corporate governance to resolve them. In spite of these arguments, there is a global concern for the application of corporate governance to SMEs. It is often argued that similar guidelines that apply to listed companies should also be applicable to SMEs. Jensen (1993) gives an example of what should be looked at when trying to improve a governance structure. Efficient systems have six key elements. Effective governance systems are characterised by:

1. limited partnership agreements at the top level that prohibit headquarters from

cross-subsidizing one division with the cash from another;

2. high-equity ownership on the part of managers and board members;

3. board members who in their funds directly represent a large fraction of the equity owners

of each subsidiary company;

4. small boards of directors (of the operating companies), typically consisting of no more

than eight people;

5. CEOs who are typically the only insiders on the board; and

6. CEOs who are seldom the chairman of the board.

Applying the stakeholder approach, a firm is not just responsible to its shareholder but also its constituency of stakeholders. This approach emphasizes long term performance enhancing contributions by stakeholders and also views businesses as socially responsible institutions.

Thus, an appraisal of a firm will not only include financial performance but also employment, market share and growth in trading relations with suppliers and customers.

Indeed potentially cogent arguments have been made regarding merits of including stakeholders in governance mechanisms of corporate bodies, a class of firms which includes SMEs. The possible pros and cons of such advancements with respect to SMEs are issues we discuss further in this paper.

Benefits of corporate governance to SMEs

There are those who advocate that the advantages of corporate governance should attract SMEs especially growing entrepreneurial firms to adopt it. This section looks at such benefits and discusses them, as well as highlighting them in the Ghanaian SME context. By definition, growing entrepreneurial firms are firms that have the growth and orientation to expand beyond their state of survival. The benefits of corporate governance to listed firms could apply to SMEs as well. In this case, the benefits that accrue from corporate governance practices further assist SMEs to grow rapidly.

Entrepreneurial firms need access to resources for growth. They need inputs on business operations, good strategy and best practices in the industrial sector. These resources can be provided for through the presence of non-executive directors or external board members as in the case of listed firms. Research on listed firms has shown that strategy influences corporate performance (McGahan and Porter, 1997) and external board members challenge strategies by management (Pettigrew and McNulty, 1995). Thus the existence of external board members could lead to better management decisions and help SMEs to attract better resources. As has been noted, access to finance is one main obstacle to growth and performance of the SME sector in Ghana. Incorporation of corporate governance into the sector could greatly reduce this constraint. The infusion of external board membership in this case is crucial since there is a high incentive for the board member(s) to introduce ways of attracting finance. Non-executive directors could also introduce creativity and innovation through opinions and suggestions during decision making. In the Japan Small Enterprise Agency, SMEs with very high growth rates use non-executive directors more actively than larger firms.

Also, as entrepreneurial firms grow, the need to introduce professional governmental practices and managers arises. This begins the process of separation between management and owners. However, agency problems will still exist between non-family professional managers and owners. The underlying fact is that these non-family professionals would have to be motivated with incentives in order to gain from their expertise. In addition, for best performance from managers, governance of business units must be clear and distinct. Accounting controls and internal audits will have to be put in place to help assess the performance of these managers. This merit has dire implications forthe SMEs in Ghana which are run largely by less competent managerial staff, mostly the sole proprietor and family. Corporate governance makes room for the composition of a board which will include external directors not necessarily linked to the owner and thus induce more independent best practice methods of running the business and attaining profits. The possible tension here is that which may develop between the owner and board of directors (especially in sole proprietorships). In Ghana, as noted, one of the banes of SME development is poor managerial competencies, an SME with a corporate governance structure will better overcome these problems via the expertise and more stringent internal control measures introduced by the board members.

Also, it will free up the owner operator from operational duties as well as prevent disputes. The separation of management from control of the board mimics the division of the manager from the owner. A large listed entity faces the same issue when seeking to ensure that the managers are accountable to the owners. Often in closely-held companies, fallouts amongst the people involved revolve around misunderstandings between the managers and the owners or a failure to separate the two functions.

Corporate governance paves the way for possible future growth or a sale. Often businesses seeking new funds find that they have much work to do before confidently going to the market. It normally takes some time to be fully listed. It is within this period that corporate governance becomes crucial and the learning curve is steep. A consistent track record of good governance will greatly assist when that point comes. If SMEs infuse corporate governance structures at an early stage, they will gain experience and instil discipline in the management of the firm. This is important as external parties ensure sound management practices. Corporate governance allows firms to prepare for their pending initial public offering (IPO). For example, in Ghana, early introduction of corporate governance would prepare an SME well enough even before it gets listed under the provisional listing regime.

Efforts by the Ghana Stock Exchange to encourage listing by SMEs on the market can be complemented and sped up where such firms have effective governance structures. The existence of a board will induce rapid growth strategies in the SME for rapid profits; this will at a point require the firm going public for larger finances. Thus the transition from a small to medium and finally large company will be smoothly aided by an effective corporate control system.

Similarly, good corporate governance practices assist SMEs in improving on their prospects of obtaining funding from investors and financial institutions. This is an exact consequence of proper bookkeeping and accounting practices and information disclosure which increases the confidence of investors in the firm. The SME will also have a healthier growth and be committed to business efficiency due to the presence of external supervisory parties.

Applying good governance principles reduces the problems associated with information asymmetry and makes the SME less risky to invest in.

However, attention should also be drawn to the disadvantages of corporate governance. The introduction of corporate governance will mean additional roles in audit, remuneration and nomination committees, new and more directors have to be hired. The non-executive directors will also have to be paid higher remuneration because of active roles they will be playing. Thus introduction of corporate governance into activities of SMEs will increase operational costs in the form of higher start-up cost which could deter many from starting business. The government can resolve this problem through the introduction of subsidies for the SMEs.

It is important at this stage to dwell on a previously alluded to issue of stakeholder theory on corporate governance. From the analysis so far it is quite clear that corporate governance bothers around the role a board plays in directing the agent (manager) of a firm to attain the prime objective of its principal (shareholder) to fulfil a contractual obligation. However, for proponents of stakeholder theory, shareholders are only a proportion of an important stakeholder group. Hence corporate governance mechanisms must incorporate these other stakeholders. The incorporation of these groups of stakeholders on the board of firms will

CORPORATE GOVERNANCE AND SMEs

Corporate governance has typically been linked to bigger businesses and the presence of the intervention problem. The interactions between shareholders and managers give rise to agency problems. It occurs when organisation members have conflicts of interest with the company.

It should also be applicable to SMEs. Six crucial components make up effective systems. Effective governance systems exhibit the following traits[10]:

1. top-level limited partnership agreements that forbid headquarters from funding one division with funds from another;

2. substantial equity stake by board members and managers;

3. members of the board who, in their individual capacity, directly represent a sizable portion of the equity owners of each subsidiary firm;

4. tiny boards of directors, often no more than eight members (of the running firms);

5. CEOs, who frequently make up the board's only insiders; and

6. CEOs who aren't often the board chairman. When using the stakeholder method, a company is accountable to both its constituency of stakeholders and its shareholders.

This approach regards businesses as socially responsible entities and focuses on stakeholders' long-term performance-enhancing contributions. As a result, an evaluation of a firm will consider not just its financial success but also its growth in terms of market share, employment, and business relationships with suppliers and clients. In fact, there have been some potentially persuasive arguments made in favour of involving investors in the governance processes of corporate entities, a class of businesses that contains SMEs[11].

Growing enterprises are entrepreneurial businesses that have moved beyond the point of survival and are focused on expansion. SMEs may benefit from corporate governance in the same ways that publicly traded corporations do. In this case, the benefits of corporate governance practises aid SMEs in accelerating their pace of growth. Entrepreneurial enterprises need access to resources in order to grow. They need guidance on strong strategy, efficient company practises, and market best practises. Non-executive directors or outside board members may support these resources, much like in the case of publicly traded corporations.

[10] Capital Electronics and Appliances Ltd and Others *Versus* Reserve Bank of India and Others, Writ Petition (Civil) No.373 of 2018

[11] Roles of stakeholders in business organizations, article – Compliance prime, 2017

Having outside board members could therefore lead to better management decisions and help SMEs draw in greater resources.[12]

Corporate governance could significantly ease this restriction if it were implemented in the sector. Since there is a strong motivation for the board member(s) to offer strategies for attracting funding, the addition of external board members is essential in this situation.

Through their thoughts and opinions, non-executive directors may also add creativity and innovation to the decision-making process. However, issues with agency will remain between owners and non-family professional managers. The truth is that in order to benefit from their skills, these non-family experts would need to be motivated by rewards.

Corporate governance creates space for a board that includes external directors who aren't always connected to the owner and encourages more independent best practises for managing the company and generating profits. The potential conflict here is one that might arise between the owner and the board of directors (especially in sole proprietorships).

Corporate governance prepares the way for potential expansion or a sale in the future. Businesses that are looking for new funding frequently discover that they have a lot of work to do before firmly entering the market. To be fully listed usually takes some time. Corporate governance becomes important during this time, and the learning curve is very steep. When that time comes, a track record of reliable good governance will be quite helpful.[13]

TRANSITION FROM SMALL MEDIUM ENTREPRISE TO A LARGE COMPANY

SMEs will gain management experience and discipline if they incorporate corporate governance systems early on. This is crucial because third parties guarantee good management practises. Corporate governance enables businesses to get ready for their upcoming IPO. A board will encourage rapid expansion plans in the SME for quick profits; eventually, this will necessitate the company going public for bigger funds. As a result, a solid corporate control system will enable a small corporation to grow into a medium-sized one and finally a huge one. High corporate governance standards also improve SMEs' chances of getting funding from

[12] Jensen (1993) gives an example of what should be looked at when trying to improve a governance structure, https://www.sciencedirect.com/science/article/pii/S0378426698000053 accessed 24th Nov 2022

[13] 2017 NLS Bus L Rev 55, A Critical Analysis of the Relationship between Ownership and Corporate Governance

investors and financiers. Good bookkeeping, accounting, and information exchange practises are directly responsible for this, which boosts investor confidence in the business. [14]

CONCLUSION

It is impossible to overstate the crucial as per of corporate governance because it creates the organisational climate for a company's internal actions. By encouraging better management practises, stronger inner auditing, and more prospects for evolution, corporate governance may significantly help the SME sector. Businesses that are looking for new funding regularly discover that they have a lot of work to do before firmly entering the market. When that time comes, a track record of consistent good governance will be quite helpful. In addition, we contend that SMEs in particular need a bottom-up method that clearly states the viewpoints of unions (in the case of workers) during board meetings in order to effectively articulate the role of other investors. It must be understood that effective corporate governance does not ensure commercial success. However, bad ascendancy could be a sign of a failing company. More prominently, it is a worthwhile objective to increase the confidence of current owners and possible new ones.

[14] Unlocking growth in small medium enterprises, (article) 2019