

# CORPORATE GOVERNANCE COMPLIANCE AND FIRM VALUE: EVIDENCE FROM INDIAN MSMEs.

<sup>1</sup>Sravani Maddileti, <sup>\*2</sup>Dr. Gautami S.

<sup>1</sup>Research Scholar, Department of Management, Jawaharlal Nehru Technological University, Anantapur, Ananthapuramu, Andhra Pradesh, India Email: [msravanidhar@gmail.com](mailto:msravanidhar@gmail.com) ORCID:0009-0001-7977-0897

<sup>\*2</sup>Professor, Department of Management Studies, Sri Venkateswara College of Engineering (Autonomous), Tirupati, Andhra Pradesh, India Email: [gautami.s@svcolleges.edu.in](mailto:gautami.s@svcolleges.edu.in) ORCID: 0000-0002-5667-1343

**\*Corresponding Author:**

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## **ABSTRACT**

Corporate governance has traditionally been associated with large, publicly listed corporations. However, its relevance to Micro, Small and Medium Enterprises (MSMEs) is increasingly recognized, particularly in emerging economies. Although MSMEs often operate under owner-managed structures with minimal separation between ownership and control, governance mechanisms remain essential for ensuring transparency, accountability, access to finance, and sustainable growth. This study conceptually examines the applicability of corporate governance principles to MSMEs. It analyses the theoretical foundations of governance, including agency theory and stakeholder theory, and evaluates how governance structures can enhance managerial efficiency, reduce financial constraints, and support long-term expansion. The paper also explores the transition of MSMEs into larger enterprises through structured governance mechanisms. The findings suggest that the adoption of governance practices, even in simplified forms, significantly strengthens the managerial and financial foundation of MSMEs.

**Keywords:** Corporate Governance, MSMEs, Agency Theory, Stakeholder Theory, Entrepreneurship, Financial Accountability

## **INTRODUCTION**

Corporate governance refers to the system through which business entities are directed and controlled. It establishes a framework of rules, practices, and processes that guide managerial decision-making while safeguarding stakeholder interests. While governance systems are strongly emphasized in listed corporations, MSMEs often overlook their importance due to concentrated ownership structures.

In many MSMEs, the owner simultaneously functions as manager, financier, and decision-maker. This limited separation between ownership and control has led to the assumption that governance frameworks are unnecessary. However, as MSMEs expand, attract external capital, or diversify operations, governance mechanisms become increasingly critical.

A well-designed governance structure improves strategic planning, enhances financial credibility, and facilitates sustainable growth. Therefore, the study of corporate governance within MSMEs is particularly significant in developing economies where MSMEs contribute substantially to GDP, employment, and exports.

## **2. RESEARCH OBJECTIVES**

The major objectives of this study are:

- To explore the theoretical foundations and structural dimensions of Micro, Small and Medium Enterprises (MSMEs) and understand their key operational characteristics.
- To investigate the importance of corporate governance in developing economies, particularly in enhancing transparency, accountability, and institutional efficiency.
- To study the growth trajectory of MSMEs and examine the factors influencing their transition into large-scale enterprises.
- To assess the advantages and constraints of adopting corporate governance practices in MSMEs

## **3. RESEARCH METHODOLOGY**

This research adopts a doctrinal methodology. The study relies on:

- Primary sources such as statutory provisions and regulatory frameworks.
- Secondary sources including books, journal articles, research papers, and institutional reports.

The approach is analytical and conceptual in nature.

## **4. MICRO, SMALL AND MEDIUM ENTERPRISES (MSMEs)**

Micro, Small and Medium Enterprises are independently owned and managed business entities characterized by limited market share, localized operations, and personalized management structures.

In India, MSMEs play a critical economic role:

- Contribute significantly to GDP.
- Account for a substantial share of industrial production.
- Generate employment after agriculture sector.
- Support innovation and entrepreneurial development.

### **Key Characteristics of MSMEs:**

- ownership and management responsibilities are closely integrated, with the owner actively involved in overseeing day-to-day operations.
- Capital is primarily sourced from personal savings or financial support from family members rather than formal institutional channels.
- The scope of business activities is generally confined to local or regional markets.
- Management practices tend to be informal, often lacking standardized systems and structured procedures.
- Furthermore, decision-making authority is highly centralized, typically concentrated in the hands of the owner or a small group of key individuals.

## **5. BENEFITS AND CHALLENGES OF MSMEs**

### **Benefits**

- SMEs maintain strong agility in decision-making because of their streamlined structure.
- They are capable of adjusting rapidly to shifts in market demand and competitive conditions.
- Direct supervision by owners or top managers ensures effective operational oversight.
- The limited presence of formal procedures reduces administrative complexity and speeds up execution.

### **5.2 Challenges**

- Access to external and institutional financing remains a significant constraint.
- Internal control frameworks are often inadequate or insufficiently developed.
- Financial record-keeping and accounting systems may lack formal structure and standard practices.
- Business continuity is highly reliant on a few key individuals.
- Formal succession strategies are often absent or poorly implemented.
- Limited availability of professional management expertise restricts strategic expansion and sustainability.

These challenges highlight the need for structured governance even in smaller enterprises.

## 6. CORPORATE GOVERNANCE: CONCEPTUAL FRAMEWORK

Corporate governance can be defined as the system by which companies are directed and controlled. It determines the distribution of rights and responsibilities among shareholders, directors, managers, and other stakeholders.

Two major theoretical foundations guide corporate governance:

### Agency Theory

Agency problems arise when ownership and management are separated. Managers may pursue personal interests rather than shareholder wealth maximization. While SMEs often combine ownership and management, agency issues may arise when:

- Professional managers are hired.
- External investors participate.
- Family conflicts emerge.

### Stakeholder Theory

Stakeholder theory expands corporate responsibility beyond shareholders to include employees, suppliers, creditors, customers, and society. SMEs, due to their local and community-oriented nature, are deeply connected with stakeholder networks. Governance structures ensure balanced stakeholder engagement.

## 7. CONSEQUENCES OF INADEQUATE CORPORATE GOVERNANCE IN SMEs

Weak corporate governance in SMEs can give rise to multiple organizational risks and inefficiencies:

**Lack of Strategic Direction:** Without formal planning mechanisms, enterprises may struggle to align their objectives with long-term growth goals.

**Internal Ownership Disputes:** Conflicts among partners or family stakeholders can create instability and disrupt business continuity.

**Ineffective Financial Administration:** Poor accounting systems and insufficient internal controls increase the likelihood of financial irregularities and misallocation of resources.

**Constraints in Raising Capital:** Limited transparency and weak governance structures reduce investor confidence and restrict access to external funding.

**Favoritism in Appointments:** The selection of relatives or associates without adequate qualifications may undermine professionalism and performance.

**Heightened Operational Risk:** Heavy dependence on a few individuals exposes the enterprise to leadership and succession vulnerabilities.

### Deficient Accountability Structures:

The absence of formal oversight mechanisms, such as advisory boards, weakens monitoring and responsible governance practices.

## 8. ADVANTAGES OF ADOPTING CORPORATE GOVERNANCE IN MSMEs:

The implementation of corporate governance mechanisms generates multiple strategic and operational benefits for SMEs:

**Greater Financial Credibility and Funding Opportunities:** Systematic financial disclosure and transparent reporting practices enhance stakeholder trust, reduce information gaps, and improve the enterprise's ability to secure external finance.

**Access to Broader Strategic Insight:** The involvement of independent or external directors contributes specialized industry knowledge, innovative thinking, and unbiased judgment in strategic decisions.

**Institutionalization of Management Practices:** Governance frameworks facilitate the separation of ownership from managerial functions, establish clearly defined roles and responsibilities, introduce structured performance appraisal systems, and strengthen internal audit and control procedures.

**Enhanced Risk Oversight:** Formal governance bodies improve monitoring mechanisms, reduce the likelihood of fraud and mismanagement, and promote financial prudence and accountability.

**Foundation for Scalable Growth:** Early adherence to governance norms positions SMEs for future expansion avenues, including public offerings, venture capital investment, institutional funding, and strategic alliances or mergers.

## 9. TRANSITION FROM SME TO LARGE ENTERPRISE

The transformation from a small enterprise to a large corporation requires:

- Structured governance mechanisms
- Strong internal controls
- Professional management teams
- Transparent reporting systems
- Board-level oversight

Corporate governance facilitates smooth scaling by creating organizational discipline. As firms grow, separation of control becomes inevitable. Early governance adoption eases this transition and reduces structural conflicts.

## 10. CONSTRAINTS AND COST IMPLICATIONS OF CORPORATE GOVERNANCE IN MSMEs:

While corporate governance provides long-term advantages, its adoption in SMEs may involve certain practical and financial limitations:

**Additional Financial Commitments:** The establishment of governance mechanisms, such as audit committees and the appointment of external directors, increases operational costs through professional fees and remuneration expenses.

**Expanded Administrative Responsibilities:** Compliance with formal governance standards requires greater documentation, reporting, and procedural adherence, thereby increasing the administrative burden.

**Challenges in Formalization:** SMEs operating within traditionally informal or family-driven management cultures may encounter resistance or difficulty in adapting to structured governance systems.

To address these concerns, governments and regulatory authorities can facilitate smoother adoption by offering financial incentives, training and awareness programs, and simplified governance models tailored specifically for smaller enterprises.

## 11. CONCLUSION

Corporate governance is not confined to large corporate entities; it holds equal significance for Small and Medium Enterprises (SMEs). The adoption of structured governance practices fosters transparency, accountability, and strategic clarity, thereby reinforcing organizational resilience. Even though agency-related conflicts may be relatively limited in owner-managed firms, concerns such as inadequate managerial capabilities, financial irregularities, and succession uncertainties make the establishment of governance frameworks essential.

Robust governance mechanisms build stakeholder trust, enhance access to investment, and promote sustainable business development. While governance practices do not automatically ensure success, weak governance structures often indicate underlying operational and strategic fragilities.

Therefore, it is imperative to develop and implement a proportionate, adaptable, and scalable governance framework tailored to the unique characteristics of SMEs to secure their long-term competitiveness and contribution to economic growth.

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