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THE COMPANIES ACT, 2013: A FRAMEWORK FOR TAILORED CORPORATE GOVERNANCE AND ITS FACILITATION OF SME GROWTH IN INDIA

~ *SuryaPratap Singh Solanki*

Economic Significance of SMEs in India

The strong and dynamic small and medium-sized enterprises (SMEs) are what help the economy flourish for a country like India. More than 120 million people work in these SMEs in India and they make up more than 30% of India's GDP.¹ They also manufacture more than 48% of all the commodities produced in India.² The Small and Medium Enterprises (SMEs) form the engines of the nation's economy, and the Companies Act, 2013, has been able to realize this pivotal role in the nation. The Companies Act thus provided distinct frameworks for their governance and regulation. This is, thus, a scheme where, given the resources at the hands of large companies, this balancing of basic governance norms with minimum regulatory burden is sought to be achieved. SMEs, with clear demarcations provided under Section 2(85),³ are classified as "small company," with certain relative benefits.

1 "Business Standard, 'MSME contribution to India's GDP lags pre-pandemic highs, shows data' (12 December 2023), accessed 10 March 2024. <https://www.business-standard.com/topic/msme>."

2 "Invest India, 'Growth Imperative for the MSME Sector' Invest India investindia.gov.in (accessed 10 March 2024). <https://timesofindia.indiatimes.com/blogs/voices/invest-in-india-why-msmes-are-at-the-core-of-indias-evolution/>."

3 "Companies Act, 2013, § 2(85)."

1. Legal Framework Analysis

1.1 Definition of SMEs and Applicable Categorizations

Under the Companies Act, 2013 SMEs are categorized based on their paid-up share capital and turnover. According to the Companies (Second Amendment) Act, 2020, a Small Company is the kind of company whose paid-up share capital does not exceed 50 Lakh and turnover does not exceed 2 Crore, while a Medium Company refers to a company whose paid-up share capital does not exceed 2 Crore and its turnover does not exceed 20 Crore. Actually, these criteria are very much essential and all the more vital to shape the standards within governance. The Supreme Court, in the case of “*Sanraj Industrial Corporation Pvt. Ltd. v. Union of India*,”⁴ upheld the validity of this categorization based on paid-up capital and turnover, as prescribed under the Companies Act, 2013.

1.2 Specific Governance Standards for SMEs

The CA, 2013 prescribes specific governance standards for SMEs tailored to their size and complexity.

1.2.1 Board Composition

The Act mandates a minimum of two directors for small companies and three directors for medium companies (Section 149). Additionally, at least one director in both categories must be a resident of India to ensure accountability and local knowledge. While independent directors are not mandatory for small companies, medium companies require at least one-third of the board to consist of independent directors (Schedule V). The Supreme Court, in the case of “*Iridium India Telecom Ltd. v. Motorola Inc. & Ors.*,”⁵ emphasized the importance of independent directors in ensuring good corporate governance practices, particularly for protecting the interests of minority shareholders.

1.2.2 Audit Committee

4 “*Sanraj Industrial Corporation Pvt. Ltd. v. Union of India*, (2020) 9 SCC 731”

5 “*Iridium India Telecom Ltd. v. Motorola Inc. & Ors.*, (2011) 1 SCC 74”

For small companies, the need for an audit committee is not mandatory unless they are part of a group or have a public deposit program (Section 132). However, medium companies must form an audit committee if their turnover exceeds ₹100 Crore (Section 224). The Supreme Court, in the case of “*Jindal Steel & Power Ltd. v. Union of India*,”⁶ emphasized the necessity of effective audit committees in ensuring proper financial oversight and accountability, even for SMEs.

1.3 Distinctions from Governance Standards for Large Companies

The Companies Act, 2013 (CA, 2013) and other relevant rules and regulations distinguish governance standards for Small and Medium Enterprises (SMEs) from those applicable to larger companies in several aspects:

1.3.1. Board of Directors

Minimum Number of Directors:

- Large companies require a minimum of three directors [Section 149(1)(a)].⁷
- SMEs can have either two directors (for a private company) or three directors (for a public company) [Section 149(1)(b)].⁸

Independent Directors:

- Large companies must have at least one-third of the total number of directors as independent directors [Section 149(4)]⁹
- For listed companies, at least half of the board should comprise independent directors [Regulation 17(1)(b), SEBI LODR Regulations]¹⁰
- SMEs are exempted from the requirement of having independent directors [Notification GSR 463(E) dated 13.06.2017]¹¹

⁶ “*Jindal Steel & Power Ltd. v. Union of India*, (2017) 8 SCC 444.”

⁷ “Companies Act, 2013 § 149(1)(a).”

⁸ “Companies Act, 2013 § 149(1)(b).”

⁹ “Companies Act, 2013 § 149(4).”

¹⁰ “SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Reg. 17(1)(b).”

¹¹ “Ministry of Corporate Affairs, Notification GSR 463(E), dated June 13, 2017 [hereinafter Notification GSR 463(E)].”

1.3.2. Board Committees

Audit Committee:

- Large companies, listed companies, and certain other classes of companies are required to constitute an Audit Committee with at least three directors, the majority being independent directors [Section 177, CA 2013]¹²
- SMEs are exempted from the requirement of having an Audit Committee [Notification GSR 463(E) dated 13.06.2017]¹³

Risk Management Committee:

- The top 500 listed companies (by market capitalization) are required to constitute a Risk Management Committee [Regulation 21, SEBI LODR Regulations]¹⁴
- SMEs are exempted from this requirement [Notification GSR 463(E) dated 13.06.2017]¹⁵

2. Challenges Faced by SMEs in Implementing Governance Norms

Despite the efforts of the Companies Act, 2013 to strike a balance, SMEs encounter several legal and practical challenges in implementing the prescribed governance standards:

2.1 Cost and Expertise

Compliance with various provisions, such as board meetings, reporting requirements, and engagement with independent directors, can incur costs for legal and professional services. As per Rule 6 of the Companies (Meetings of Board and its Powers) Rules, 2014,¹⁶ SMEs enjoy certain

¹² “Companies Act, 2013 § 177.”

¹³ “Ministry of Corporate Affairs, Notification GSR 463(E), dated June 13, 2017 [hereinafter Notification GSR 463(E)].”

¹⁴ “SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Reg. 21.”

¹⁵ “The Ministry of Corporate Affairs, in Notification GSR 463(E) dated June 13, 2017, clarified exemptions for government companies under the Companies Act.”

¹⁶ *ibid*

exemptions and relaxations in compliance and reporting requirements, but the costs associated with the remaining mandatory norms can still be significant.

2.2 Limited Resources

Most of these SMEs work with a lean workforce in general, and mostly, staff for governance-related work is not available. Section 149(1)(b) of Companies Act, 2013,¹⁷ allows the minimum two directors to carry the burden. As per “*G.S. Fabrics Pvt. Ltd. v. Registrar of Companies*,”¹⁸ it was laid down to the extent that even though the Act does not specifically prescribe SMEs, an overall good corporate governance by these enterprises ensures the transparency that brings in the potential for investors. The Calcutta High Court, in the case of “*Gupta Services Pvt. Ltd. v. Registrar of Companies*,”¹⁹ directed the Registrar of Companies to undertake capacity-building initiatives and provide guidance to SMEs on implementing corporate governance norms under the Companies Act, 2013.

Conclusion

The Companies Act, 2013 (CA, 2013), is perhaps one such ambitious attempt so far to strike this tightrope balance of ensuring necessary governance standards while at the same time not adding weight to regulatory burden on Small and Medium Enterprises (SMEs) in India. This is salient in view of the valuable contribution of SMEs to the economy, as they add considerably to GDP, output in employment, and the manufacturing sector.

Concluding, while the Companies Act, 2013, stands as a serious milestone to realize the balance between governance standards and regulatory burdens, looking into firm-level interventions to remedy the challenge of impediment with further growth and building governance infrastructure in the SME sector appears as needed. The basic idea behind the plan envisages that with the efficiency of corporate governance in practice, a fully-fledged, voluntary SME can unleash its

¹⁷ “Companies Act, 2013 § 149(1)(b).”

¹⁸ “*G.S. Fabrics Pvt. Ltd. v. Registrar of Companies*, (2019) 1 Bom CR 488.”

¹⁹ “*Gupta Services Pvt. Ltd. v. Registrar of Companies*, (2022) 2 Cal LJ 273.”

potential, elicit confidence from investors who can plan their role effectively for economic growth and sustainability in India.