

What's in a classification? Everything if you are an MSME

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The recent move (February 7, 2018) of the Union Cabinet to change classification norms for MSMEs from 'investment in plant and machinery/equipment' to 'annual turnover' is a big relief for the MSME sector.

As per the new classification, enterprises with annual turnover less than or equal to Rs 5 crore fall under the 'micro' category, those between Rs 5 crore to Rs 75 crore as small enterprises, and those with turnover between Rs 75 crore and Rs 250 crore will be classified as medium enterprises. Further, there is no distinction between manufacturing and service units. This is a welcome and long-awaited move that will greatly improve transparency of the sector and help better measure its contribution to the GDP.

Before we look at the change in the definition and its impact, it is useful to understand why the definition of SME is important. Given the thrust that the government places on the sector, there has to be a meaningful definition to MSMEs in order that the benefits are well directed. We often hear about the allocation made for credit disbursement for MSMEs.

However, to ensure that the benefits reach the intended beneficiaries it is important to have an appropriate definition that will help in directing credit to the intended beneficiaries. An investment-based definition obfuscates the actual credit requirements for operations which is unrelated to the capital investment. Using an investment based definition may pave way for inefficiencies, with the focus being on extending or limiting the investment in order to fulfil the criteria rather than being based on the business requirements.

The turnover criteria will also help the units move seamlessly from one category to another (Micro to Small and Small to Medium). Under the investment criteria, there was a need to increase investment for a unit to move up the chain, which may not have been required in many cases except for satisfying the definition.

Further, the MSME sector attracts a lot of attention and support from multilateral agencies who would require a definition that is in alignment with the global benchmarks. Worldwide, MSMEs are defined in terms of both turnover and number of employees. Therefore the turnover definition is a step towards a harmonised classification.

The new definition will bring clarity on multiple fronts. While removing the arbitrary nature of the earlier definition, turnover-based definition is expected to deliver results for the overall development of the MSME sector. One important advantage that the new definition is expected to deliver is a better understanding of the credit needs of the MSME units by the banks. Given that working capital requirements are more a function of the operations rather than capital investment, turnover will be a better measure to assess the funding requirements and accordingly a more realistic allocation of credit is possible.

The new norms considering annual turnover for reclassification will reflect a clearer picture regarding MSMEs. The earlier norms were prone to present skewed data as older enterprises with historical investment value would be termed as micro units, whereas a similar set-up today would be qualified as medium or large based on the current much higher value of investment. This became a deterrent for new entrants, especially in sectors requiring large capital expenditure.

Similarly, using 'investment in plant and machinery/ equipment' as the measure to be qualified as MSME required self-declaration of investment, which in turn is disposed to manipulation and underreporting of asset value. Using turnover to classify would curb this practice and at the same time bring down asset verification costs.

The earlier norm unintentionally hampered investment in the sector as increased fixed assets would mean that the incentives receivable as a small or medium enterprise would reduce or stop. Reclassification basis annual turnover is likely to stimulate investment by removing this anomaly.

Another significant benefit that the new definition can bring about is the manner in which the assets are funded. On account of the investment criteria, MSMEs were to a large extent not able to enjoy the benefits of asset-light financing options such as operating lease and shared ownership of assets.

The turnover based criterion is aligned to the GST regime and together, they are likely to create a transparent and objective environment for the sector. This will foster higher productivity, efficiency and improved ease of doing business. This would have a positive effect on employment generation and investment in the MSME sector which is essential to propel the economy to the next level of growth.

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