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Risk Management in Micro, Small and Medium Enterprises (MSMEs) in India: A Critical Appraisal

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ABSTRACT

Risk Management, a term often linked to major corporations as a corporate governance requirement, is a useful process that MSME's can adopt to improve their chances of sustained and successful longevity. Over the years, risk management has been identified as a vital process in the business institutions. It is further believed that risk management is less developed within the small business sector where strong enterprise culture can only help in managing risk in a professional and structured way. This study focuses to investigate the risk management practices small and medium enterprises in India. The attitudes of the owner managers and their knowledge towards risks play an essential role in how systematically risks are handled. Therefore, this study stresses the need of improving current planning system within the MSMEs together with enhancing the owner managers' knowledge and awareness regarding risks management through proper training and development. Risk management highlights the fact that the survival of a business entity depends heavily on its capabilities to anticipate and prepare for the change rather than waiting for the change and then react to it. It should be clearly understood that the objective of risk management is not to prevent or prohibit taking risk, but to ensure that the risks are consciously taken with complete knowledge and clear understanding so that it can be measured to help in mitigation.

KEY WORDS: Risk Management, MSME, Manufacturing, Service, Indian Economy.

Introduction

The Micro, Small and Medium Enterprises (MSME) sector has been recognized as engine of growth all over the world. Many countries of the world have established a SME Development Agency as the nodal agency to coordinate and oversee all Government interventions in respect of the development of this sector.

There exist several definitions of the term small and medium enterprises (SMEs), varying from country to country and varying between the sources reporting SME statistics. The commonly used criteria at the international level to define SMEs are the number of employees, total net assets, sales and investment level. If employment is the criterion to define, then there exists variation in defining the upper and lower size limit of a SME.

The European Union makes a general distinction between self-employment, micro, small and medium sized businesses based on the following criteria:

Number of employees

0	**Self-employed**
2-9	**Micro business**
10-49	**Small business**
50-249	**Medium-size business**

Source: ***Effective Policies for Small Business: A Guide for the Policy Review Process and Strategic Plans for Micro, Small and Medium Enterprise Development (2004), UNIDO and OECD, (http://www.unido.org/fileadmin/user_media/Publications/Pub_free/Effective_policies_for_small_business.pdf)***

In the case of India, also Medium establishment has for the first time been defined in terms of separate Act, governing promotion and development of Micro, Small and Medium Enterprises (MSME) i.e. Micro, Small and Medium Enterprises (MSME) development Act, 2006 (which has come into force from 02nd Oct, 2006) the Office of Development Commissioner (Micro, Small and Medium Enterprises) functions as the nodal Development Agency under the Ministry of Micro, Small and Medium Enterprises (MSME).

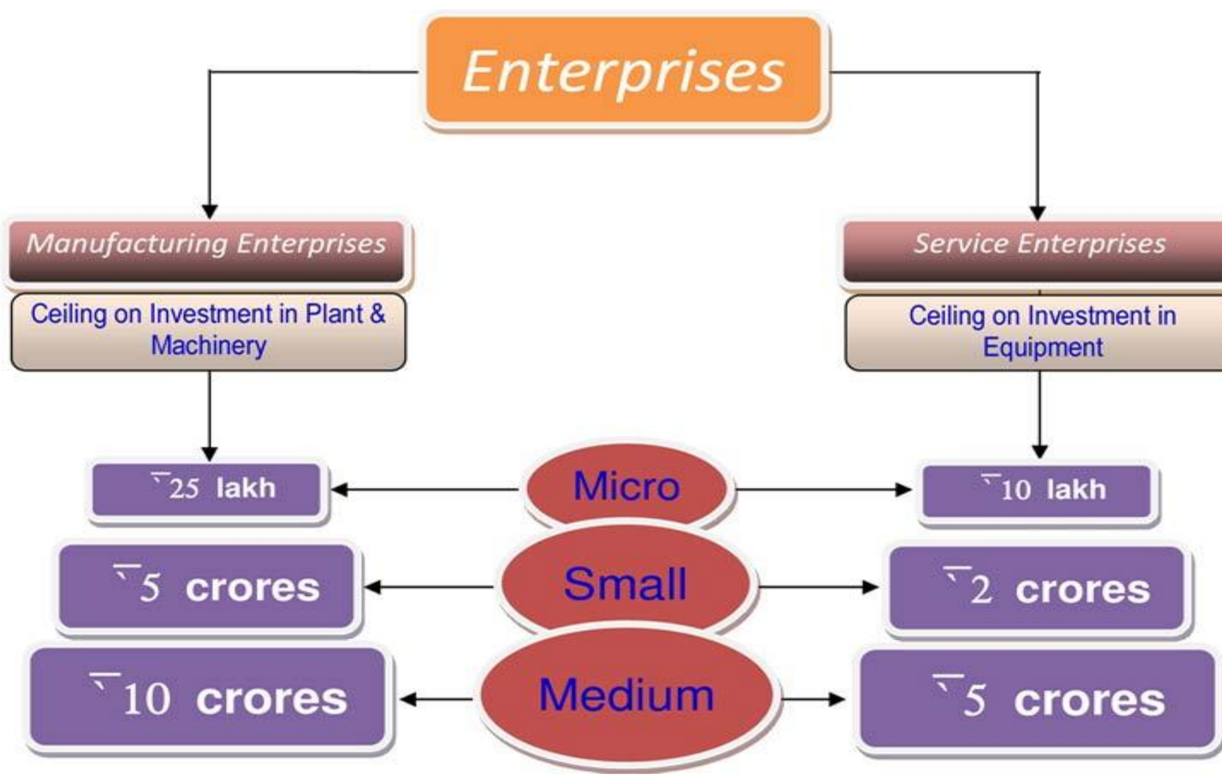
In accordance with the provision of Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 the Micro, Small and Medium Enterprises (MSME) are classified in two Classes:

(a) **Manufacturing Enterprises-** The enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the industries (Development and regulation) Act, 1951). The Manufacturing Enterprises are **defined in terms of investment in Plant & Machinery.**

(b) **Service Enterprises**: The enterprises engaged in providing or rendering of services and are **defined in terms of investment in equipment**.

The limit for investment in plant and machinery / equipment for manufacturing / service enterprises, as notified, vide S.O. 1642(E) dtd.29-09-2006 are as under:

Manufacturing Sector	
Enterprises	Investment in plant & machinery
Micro Enterprises	Does not exceed twenty five lakh rupees
Small Enterprises	More than twenty five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but does not exceed ten crore rupees
Service Sector	
Enterprises	Investment in equipments
Micro Enterprises	Does not exceed ten lakh rupees:
Small Enterprises	More than ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five core rupees



Role of MSMEs

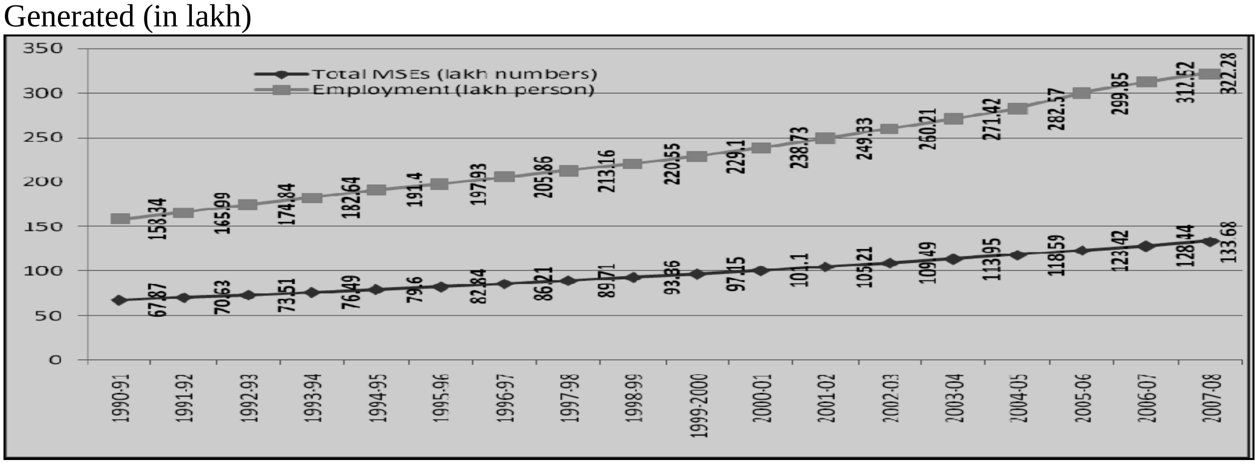
Worldwide, micro, small and medium enterprises (MSMEs) have been accepted as the engine of economic growth and for promoting equitable development. MSMEs constitute over 90% of total enterprises in most of the economies and are credited with generating the highest rates of employment growth and account for a major share of industrial production and exports. In India too, the MSMEs play a pivotal role in the overall industrial economy of the country. MSMEs in India account for more than 80% of the total number of industrial enterprises and produce over 8000 value-added products. It is estimated that in terms of value, the sector accounts for 45% of the manufacturing output and 40% of the total export of the country and employs over 6 crore people.

Further, in recent years the MSME sector has consistently registered higher growth rate compared to the overall industrial sector. The major advantage of the sector is its employment potential at low capital cost. As per available statistics, this sector employs an estimated 6 crore persons spread over 2.6 crore enterprises and the labour intensity in the MSME sector is estimated to be almost 4 times higher than the large enterprises.

Importance of the MSME sector

The contribution of micro, small and medium enterprises (MSME) sector to manufacturing output, employment and exports of the country is quite significant. According to estimates, in terms of value, the sector accounts for about 45 per cent of the manufacturing output and 40 percent of the total exports of India. The MSME sector employs about 42 million persons in over 13 million units throughout the country. There are more than 6000 products, ranging from traditional to high-tech items, which are being manufactured by the Indian MSMEs.

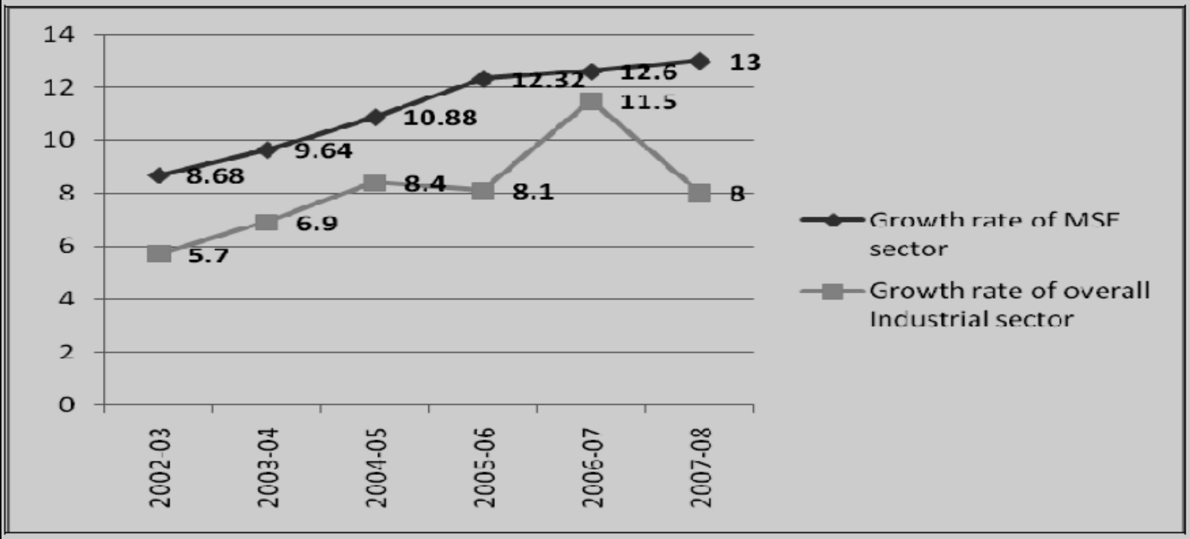
Graph 1: Trends in the growth of Micro and Small Enterprises (MSEs) and the Employment Generated (in lakh)



Source: Annual Report, 2008-09. Ministry of Micro, Small and Medium Enterprises, ***www.msme.gov.in***

It can be deciphered from the ***graph 1*** that the number of MSEs has increased steadily in India from 67.87 lakhs in 1990-91 to 133.68 lakhs in 2007-08. This could be possible due to the conducive policy environment during the liberalization era (post 1991). Similarly, number of persons employed in MSEs has risen from 158.34 lakhs in 1990-91 to 322.28 lakhs in 2007-08. The yawning gap between the two lines over the years indicates that employment elasticity of the MSE sector has improved. However, much of the labour absorption has taken place in the unorganized/ informal enterprises.

Graph 2: Comparison of the growth rates in micro and small enterprises and the overall industrial sector



Source: *Annual Report, 2008-09. Ministry of Micro, Small and Medium Enterprises,* *www.msme.gov.in*

Graph 2 shows that the MSE sector observed better growth rates vis-à-vis the overall industrial sector in India.

ENTREPRENEURIAL INITIATIVE

Year	Total working MSMEs (lakh nos)	Employment (lakh nos)	Production (Rs crore)
2001-02	105.21	249.33	2,82,270
2002-03	109.49	260.21	3,14,850
2003-04	113.95	271.42	3,64,547
2004-05	118.59	282.57	4,29,796
2005-06	123.42	294.91	4,97,842
2006-07	261.12	595.66	7,09,398
2007-08	272.79	626.34	7,90,759
2008-09	285.16	659.35	8,80,805
2009-10	298.08	695.38	9,82,919
2010-11	311.52	732.17	10,95,758

Source: Micro, Small and Medium Enterprises Ministry

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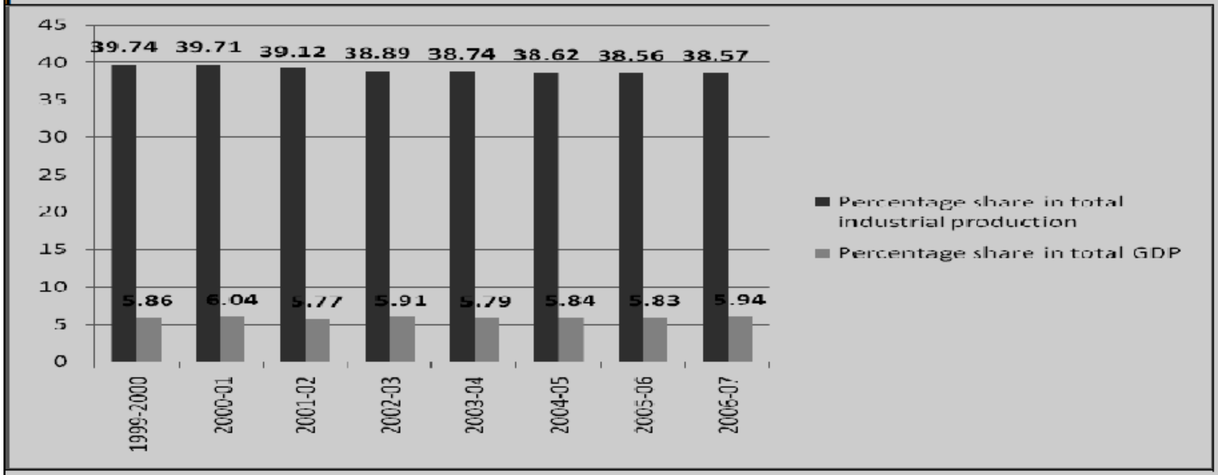
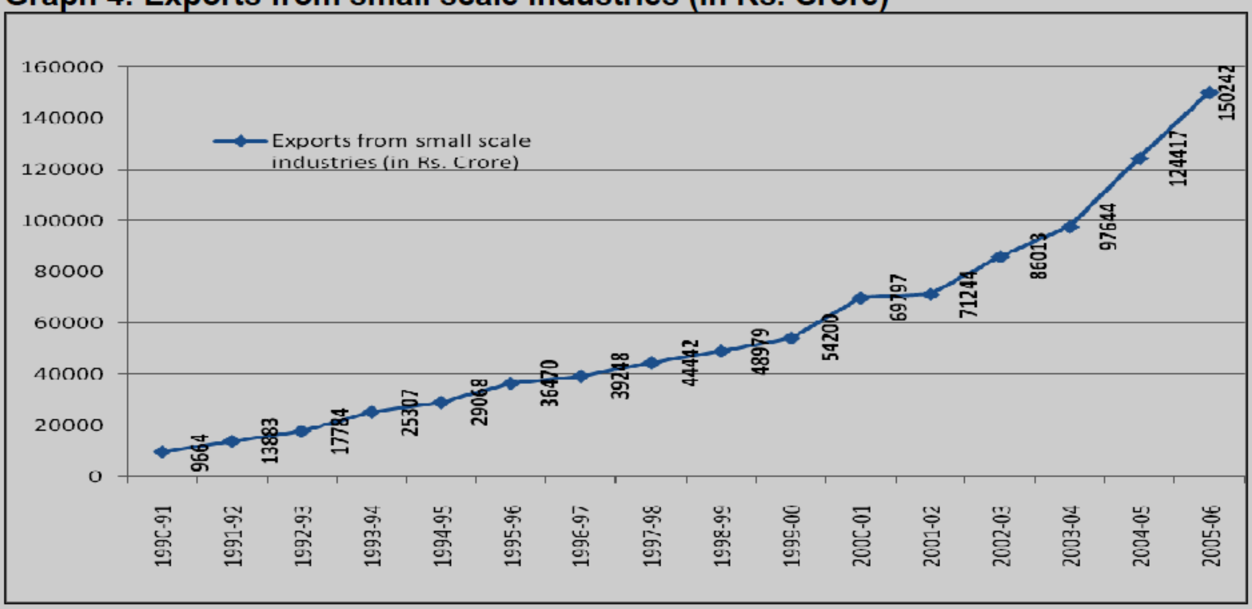
Graph 3: Contribution of MSE (%) at 1999-2000 prices in total industrial production and GDP



Source: *Annual Report, 2008-09. Ministry of Micro, Small and Medium Enterprises,* *www.msme.gov.in*

It can be witnessed from the ***graph 3*** that the contribution of the MSE sector to overall industrial production has declined marginally from 39.74% in 1999-2000 to 38.57% in 2006-07. The contribution of the MSE sector to the gross domestic product (GDP) has increased from 5.86% in 1999-2000 to 5.94% in 2006-07.

Graph 4: Exports from small scale industries (in Rs. Crore)



Source: *Handbook of Statistics on Indian Economy (2009), Reserve Bank of India*

Graph 4 shows that exports from the small scale industry has increased from Rs. 9,664 crore in 1990-91 to Rs. 1,50,242 crore in 2005-06. However, export-oriented SMEs are likely to be impacted from imminent global slowdown. Little progress has been made to diversify our export basket. Since the late 1980s, exports from SMEs continues to be dominated by just eight product groups, (namely, Readymade garments, Engineering goods, Electronic and computer software, Chemicals and allied products, Basic chemicals, pharmaceuticals and cosmetics, Processed foods, Finished leather and leather products and Plastic products) accounting for over 90 per cent of total value of exports.

The *Final Results of the Third All India Census of Small Scale Industries* (SSIs) conducted during 2001-2002 shows that the percentage of females employed in the SSI sector was 13.31 %. This shows that there exists a biasness towards men in getting employed in the SSIs. In Mizoram, Orissa, Karnataka, Goa, Lakshadweep, Kerala, Tamil Nadu and Puducherry, the percentage share of women employed was considerably higher (more than 20 %) as compared to the rest of the states and UTs.

Micro,Small and Medium Enterprises(MSMEs) are a critical economic factor in poorer countries as well as the more developed economies in the world today. They make up a majority of the domestic business transactions and at the same time play an important role in international trade. Given their size and diversity of sectors in which they function, MSMEs are highly adaptable between the developed and developing economies, provided that they have a facilitating environment to grow.

With trade barriers falling, Indian MSMEs were initially apprehensive of their ability to survive in a globally competitive environment, but over a period of time, they realized that it also provided them with greater opportunities to become part of a global supply chain as large manufacturing companies are outsourcing their production to low-cost economies. The MSMEs constitute over 90% of total enterprises in most of the economies and are credited with generating the highest rates of employment growth and account for a major share of industrial production and exports.

Issues and Problems of MSMEs

Despite being pillars of economy, , the MSMEs continue to face several problems in their day-to-day operations, that is, in production and marketing of their products. They find it difficult to sell their output at remunerative prices and cannot spend much on advertising, marketing research, etc. They also face stiff competition from large firms. Inadequate infrastructural facilities and access to credit are other major problems. MSMEs are often unable to procure adequate financial resources for the purchase of machinery, equipment and raw materials as well as for meeting day-to-day expenses. Further, they find it difficult to recruit and motivate skilled managerial and technical personnel. They are mainly reluctant to adopt modern methods of organization and management.

Despite constituting more than 80 % of the total number of industrial enterprises and supporting industrial development, many MSMEs in India have problems such as sub-optimal scale of operation, technological obsolescence, supply chain inefficiencies, increasing domestic and global competition, fund shortages, change in manufacturing strategies and turbulent and uncertain market scenario.

- **Problems in Lending**

The mind set of banks towards SMEs have somewhat changed in the recent past. With the entry of private banks, increased competition has led to a rush for lending to prime customers. The multiple financial options from the capital market have also compelled banks to take more risks in the case of SMEs. The increased lending to SMEs is propelled by the compulsion of the market as well as by the rapid expansion of these companies. The lending to the SME sector grew by 69% between 2000-01 and 2005-06.

But there exists a stark disparity amongst small players and big players within the SMEs sector. Loans to bigger companies are growing at a faster pace than loans to the SSI sector. By the end of 2006, the proportion of SSI loans to total loans has remained small at 6.4%.The Small Industries Development Bank of India (SIDBI) was set up in 1990 under the Act of Indian Parliament as the principal financial institution for promotion, financing, development of industry in the small sector and coordinating the financial activities of other institutions engaged in similar activities.

- **Problems in Marketing of Products**

Next to finance, marketing is the big problem area for small entrepreneurs. The survival of small entrepreneurs very much depends on sound marketing techniques. One of the most important tools in the hands of small entrepreneurs for promoting their sales is low prices coupled with credit to buyers, which give rise to number of problems at a later stage.

Marketing as a profession has not yet developed in the SME sector. Professional agencies are not engaged by small entrepreneurs on account of paucity of funds. The concept of marketing is not known to the majority of small entrepreneurs. For majority, marketing means advertisement or personal contacts. There are many ad-hoc initiatives taken by the Government to promote marketing of products/services of small units but no concrete action plan has been chalked out or targets made.

- **Lack of Latest Technology**

Modernization, technological and quality up gradation has assumed great significance in the present day context. With the inflow of latest technology reducing the cost of production and the increasing competition from within and outside, the small scale sector will have to attach more importance and pay attention to the areas of technology up gradation and modernization. However, due to lack of information on the areas of technology up gradation, entrepreneurs who have plans for technical up gradation are not to go ahead.

- **Industrial Sickness**

A host of developmental schemes launched by the Government for solving the problems of small scale industries have yet to achieve their goals to arrest sickness in SSI sector. The plight of existing small scale industries is visible in many industrial complexes wherein the industrial sheds have been converted into allied activities like showrooms, banquet halls, Restaurants, etc. There seems to be some lacuna in the implementation part of the developmental schemes.

- **Problems in Frequent Inspection**

One of the major grievances of the small scale sector is that the frequent inspections by multiple government agencies are a source of harassment. At present, 55 inspectors of different levels are visiting the small scale units, which is a cause of major concern to the small scale units. It is suggested that the government should stream line the inspection procedure. It should also include repeal of laws and regulations applicable to the sector that has become redundant.

- **Problems in Rating of MSMEs**

In spite of the increasing avenues of funding for MSMEs, credit penetration in this sector is still low. The primary reasons for this are insufficient credit information on MSMEs, low market creditability of SMEs and constraints in analysis. To tackle this problem, the SME Rating Agency of India (SMERA) was launched in 2005 by SIDBI in association with Dun & Bradstreet (D&B), Credit Information Bureau (India) Ltd and leading public and private sector banks.

Risks faced by MSMEs

Risk is omnipresent and all pervasive in any walk of life. It is more so in the business sectors, particularly in Small and Medium Enterprises (SMEs). The etymology of the word “Risk” may be traced to the Latin word *Rescum*, which means Risk at Sea. In business, risk is always measured against capital and therefore the Capital to Risk-weighted Assets Ratio (CRAR) is much in vogue. Risk is the potentiality that both expected and unexpected events may have an adverse impact on the capital and earnings. When we use the term “Risk”, we all mean financial risk or uncertainty of financial loss. If we consider risk in terms of occurrence frequency, we measure risk on a scale, with certainty of occurrence at one and certainty of non-occurrence at the other end. When the probability of occurrence or non-occurrence is equal, risk is the greatest. Risk can be broadly defined as any issue that can impact the objectives of a business entity, be it financial service or commercial. Risk Management is an ongoing process that can help improve operations, prioritize resources, ensure regulatory compliance, achieve performance targets, improve financial stability and ultimately, prevent loss/damage to the entity. Business, more so in the context of SMEs, is the art of extracting money from other’s pocket, sans resorting to violence and unethical means. But profiting in business without taking risk is like trying to live without being born. Risk taking, as all of us know, is failure prone as otherwise it would have been termed as sure taking. Every enterprise, be it small or medium, has its own objectives and mission. Risk Management plays a key role in protecting its assets and resources and ensuring that risks are reduced to an acceptable level. The essence of risk management is to reduce the risks to a reasonable and manageable level, on an on-going basis.

Risks Specific to SMEs

No doubt any business entity needs robust risk management systems but the SMEs need much more than that as they may not have wherewithal to manage and control risks due to their very size and several limitations. This is not true in the case of large corporate entities where professional personnel take care of many aspects pertaining to risk. All risk taking units must operate within approved procedures, limits and controls. There is no specific definition for

SMEs, which normally cover closely held or unlisted companies, partnership firms, proprietor concerns, etc. There exists fundamental difference between the way they function and the way they will be served in the financial market, as the character and integrity of the promoter/owner are the key and critical credit indicator and hence play a large role. In SME business, the 'gut feeling', which is subjective, is more relied upon than the 'pure analysis' that are more objective-oriented. Hence, both the business and professional relationships are rolled into one. Therefore credit rating or for that matter risk rating may not make a material difference to SME sectors. Certain misconceptions such as SMEs may get low rating, provide unreliable information, may not afford the fees for getting them rated, etc. will have to be dispelled first. However, rating agencies with specialized teams with analytical tools customized to SME sector will go a long way in putting in place proper mechanism in this regard.

Small to medium businesses are exposed to risks all the time. Such risks can directly affect day-to-day operations, decrease revenue or increase expenses. Their impact may be serious enough for the business to fail. Most business managers know instinctively that they should have insurance policies to cover risks to life and property. However, there are many other risks that all businesses face, some of which are overlooked or ignored.

Every business is subject to possible losses from unmanaged risks. Sound risk management should reduce the chance that a particular event will take place and, if it does take place, sound risk management should reduce its impact. Sound risk management also protects business wealth. Risk management starts by identifying possible threats and then implements processes to minimize or negate them.

Sound risk management can produce the following benefits:
• Lower insurance premiums
• reduced chance that the business may be the target of legal action
• reduced losses of cash or stock etc.
• reduced business down time.
This guide identifies some of the risks and areas where risks may emerge and it provides some strategies to manage them.
The SME sectors are exposed to some specific risks, some of which are discussed below:

(a) Constitution of business entity

The business entities under SME sectors are mostly proprietorship and partnership concerns. Few in the joint stock companies are private limited or closely held public limited companies. Thus, the very constitution itself may prove to be risky due to lack of professionalism and overdependence on one or two key persons for running the show. Lenders and other stakeholders in SME sector cannot afford to forget this fact.

(b) Leverage on financial structure

The nature of constitution of the business entity limits the funds mobilization efforts and leveraging capacity. There is a limit up to which a small and medium business enterprise can raise capital and borrow. This naturally affects their capacity to leverage on the financial structure.

(c) Tough competition and Inadequate margin

By virtue of the fact that most of the entities in SME sector are small players in their field, they may have to encounter tough competition from the bigger players. They face the pressure on their margins they can't raise their price but have to absorb the high input cost.

(d) Low collection in Account Receivables

As is evidenced in the increasing trend of outstanding receivables in the SSI sectors, there exists collection risk in the receivable portfolio of SME sectors for the reason that SMEs cannot dictate terms to their customers. As SME sector business entity is at the receiving end, this may put strain on the liquidity position of the business entity. However, the track record of SMEs as borrowers reveals that the default rate is low. Very low rates of bad debts may be the result of banks restricting their exposure to this sector.

(e) Incapacity to go for technological advancement

With very little financial resources and poor ability for leveraging the financial structure, the SME sectors may not have the wherewithal to go for highly sophisticated technological advancement which would help them optimize their available resources in the best way.

(f) High employee turnover

As growth prospects are very limited in SME sector, it is prone to high degree of employee turnover and this may involve lot of wastage of manpower and additional cost in the form of training and knowledge updating, affecting continuity besides lowering the productivity. Qualified and experienced personnel may not stay long as they may gain some experience and change employment. Majority of SME loans are backed by residential property and standard home loan margins apply. Where SMEs are backed by other forms of collateral the margins do not appear to be excessively above those available for large business. It may be noted that the two biggest problems faced by the SMEs are relating to Regulatory issues and unskilled employees, which collectively constitute nearly 45 to 50 per cent of the problems encountered by them. Access to finance is at the bottom end of the problem list.

(g) Micro Finance

Micro Finance can be defined as providing credit, thrift and financial related services and products of very small amount so as to improve the standard of living. In Indian context, loans up to Rs. 25,000/- are covered under Micro Finance. Number of small enterprises could be covered under these social oriented entrepreneurial activities. There can be no doubt that lenders spread their risk when they lend to this particular sector. It is under the premise that poor are bankable and micro enterprise finance through repayment incentive structure, streamlined administration and market based pricing adopting profit center approach is sustainable. This approach leads to profound changes in a cumulative causation triggered by credit to rural mass, as well as SMEs.

(h) Collateral Security

The existence of collateral means that banks do not have to rely as much as they otherwise would on detailed investigation and analysis of borrower's business. It serves as insurance to lenders and for the borrowers. It is a reflection of credit-worthiness to lenders. Extending the logic further, where the promoter of SME is willing to offer the family home as security against the amount borrowed, it serves as a catalyst to avoid default. That is to say the incentive to avoid the risk of default is likely to be stronger where the family home is used to obtain business finance.

(i) Bank Lending To SMEs

SMEs are an important part of economic growth in the country and bank lending is the primary source of external finance to them. Therefore, it is essential that banking sector responds not only effectively but also efficiently to the just needs of SMEs. When the business owners or managers know more about prospects of venture and risks facing their business than lenders, information asymmetry sets in. Where information asymmetry exists, lenders may respond by increasing lending margins to levels in excess of that which the inherent risks would require. Besides, banks may also curtail the extent of lending and resort to what is known as Credit Rationing, notwithstanding the fact that SMEs would be willing to pay a fair Risk Adjusted Cost of Capital.

Risk Management Process

The prime functions of risk management are to identify measure and more importantly monitor the risk. Risk management activity is a pro-active action in present for securing the future. Managing risk is nothing but managing change, before the risk manages the persons concerned.

Undesirable events, the probability of their occurring and their possible impact vary considerably from business to business and from industry to industry. How does a business identify and manage these particular risks?

- The first step is to identify the events which could cause a loss or disruption to the business.
- Those events should then be analyzed to ascertain the likelihood of their occurring and how serious the result would be if they did occur. Start simply by assessing each event as 'very likely', 'moderately likely' or 'very unlikely'. Prioritize them by putting a dollar value on each one (e.g. the replacement cost of a critical piece of machinery; or in the case of potential bad debts, the total value of amounts owed by customers).
- Attend to the most likely and the most expensive events first.
- For each possible event, develop procedures commensurate with the level of risk the business is willing to accept.
- Once a procedure is put in place, it should be monitored to ensure it is properly implemented and is effective.

As per the RBI guidelines, there are basically three types of risks viz Credit Risk, Market Risk and Operational Risk. While the credit risk is associated with the default of counter party, market risk relates to changes in the earnings as well as capital on account of changes in the market variables and the operational risk is the residual risk which does not directly relate to credit or market risk.

Conclusion

Functions of risk management should actually be the entity specific, dictated by the size and quality of the balance sheet, complexity of functions, technical/professional manpower and the status of Management Information System in place. Any risk management model is as good as the data input. In the present scenario, where profits are derived mainly from trading in the market, one can no longer afford to avoid measuring risk and managing its implications thereof. To the extent the SME entity takes risk consciously, anticipates adverse change and hedges accordingly, it becomes a source of competitive advantage as it can offer its products at a better price than its competitors. What can be measured can also be managed. It should be clearly understood that risk mitigation efforts are more important and vital than capital allocation against inadequate risk management system.

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