

BWR HANDBOOK MSMEs IN INDIA

**Handbook
&
Articles**

Prepared by

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Preface



MSMEs have been regarded as the engine of economic growth and development all over the world. Today, MSMEs are constituting nearly about 90% of the total enterprises in most of the economies (especially in developing economies) which creates marvellous employment opportunities and is accounting major share of exports & industrial production. In India, MSMEs are referred as Micro, Small and Medium Enterprises. Multinational companies have played a pivotal role in the emergence of Indian MSMEs as world leaders in specific products.

This sector plays an important role in the growth of GDP in the economy as it creates employment opportunities at low capital cost.

No doubt, MSME sector is contributing a lot to the Nation's economy but it is seeking support from the concerned Govt. departments, Banks, Financial institutions and Big Corporate houses on its growth path. Lack of support affects the growth of the sector in becoming more competitive in the National and International markets.

Receiving timely and adequate finance is a tedious exercise for both established as well as emerging MSMEs in India. According to the Indian Govt. survey, 90% of the total Micro units in India procure funds from friends, relatives and private lenders only. Though the Banks finance to MSME has shown an upward trend in India, yet the lenders do not feel secure about lending to this sector for number of reasons. The borrowers of this segment are considered as high risk borrowers because of insufficient assets, low capital, vulnerability to market fluctuations and high mortality rates. Further, access to equity capital is a genuine problem. At present, there is almost negligible flow of equity capital into this sector.

Keeping in view the important role played by MSMEs in Economic Development and its vital contribution in the Indian Economy and Employment. The Govt. and RBI are proactively supporting the growth of MSMEs in every possible manner.

In the current context of challenges in the economic environment, Brickwork Ratings believes that understanding the various challenges that MSMEs encounter and the need for them to create a sustainable business model.

Brickwork Ratings India Pvt Ltd is a SEBI registered credit rating agency headquartered in Bangalore. It is accredited by Reserve Bank of India to provide bank loan rating services and by NSIC to assign Performance and Credit Rating to MSMEs.

Brickwork Rating is committed to promoting financial literacy among investors / lenders, borrowers and other stakeholders. It has its offices in New Delhi, Mumbai, Chennai, Hyderabad, Ahmedabad, Kolkata, Guwahati and Bangalore.

This booklet contains four sections: Section 1 is attributed to the role of MSME sector, Section 2 on challenges faced by MSME sector and the initiatives taken by Government of India and Regulators; Section 3 provides on how MSMEs can enhance creditworthiness through credit rating and in the final section; several Brickwork Rating articles related to MSME segment.

I would like to thank my team members - Mr. R. Krishnan and Mrs. R. Rajalakshmi for their contributions to release this booklet.

D. Ravishankar
Founder Director

Preface



The business environment globally, has become so dynamic and responsive that any aberration in one part of the globe impacts the economic environment elsewhere. The diverse risks emanating from such happenings/ events can have a damaging as well as decelerating effect on the performance of enterprises. In certain sectors and industry verticals it may become irreversible. The need to strengthen and ring fencing to minimize the damage as well as provide buffer, are some of the strategies that the enterprise may have to look at in addition to the lenders ability to protect its exposure. However such capacity as well as capability needs to be measured in terms of the existing as well as estimated parameters to gauge their relative risk for pricing the products also.

Rating is one of the tools that look into the financial strength as well as the capacity to meet the commitments of the enterprise towards its stakeholders including the lenders. Since MSME sector is perceived as a high potential area, lenders look for a rating to enhance the confidence and ability to meet their financial commitments. Financial Institutions including banks have lately preferred for rated accounts for taking an exposure. This has opened up large opportunities for Raters. In several categories, rating has been made mandatory.

This backgrounder on Rating has been brought out jointly by CIMSME and Brickwork Ratings to bring forth the essentials of rating, its utility, various products and advantages available for the enterprises. It is hoped that this will be a ready reference and provide handy information at one point.

Chamber of Indian Micro Small & Medium Enterprises [CIMSME] thanks Brickwork Ratings and its team in their efforts in bringing out this backgrounder.

We wish this event on MSME Banking Excellence Awards- 2014 a great success.

Mukesh Mohan
President
CIMSME

New Delhi
10th January, 2015

About Chamber

Chamber of Indian Micro Small & Medium Enterprises (CIMSME) is an apex SME industry chamber representing the interests and wellbeing of SME sector and supports their active interaction with Banks, Financial Institutions, Concerned Ministries and other related stakeholders. The key role of the Chamber is to promote, protect and facilitate growth of trade and commerce of MSMEs in India. Towards this end, Chamber organizes Seminars, Conferences, Workshops and Training Programs and other trade promotional activities to educate, empower & sensitize awareness amongst the SMEs through sharing of experience and expertise. It also enters into intense discussions with the industry members to seek the challenges faced by them so that it could be addressed to various related Ministries for redressal. WE have membership around 15,000 Pan India.

As a CSR initiative, Chamber has set up a dedicated portal, www.SMEhelpline.com for the benefit of MSME sector. The portal provides free consultancy and listing assistance to MSME units. It is knowledge based portal carrying important updated information with details of various Govt. schemes, Funding options for MSMEs including availability of Venture Capital and Private Equity, News & Research papers on MSMEs sector, amongst other things. It is also a one stop B2B marketplace inviting sellers & buyers for undertaking business deals.

Entering into MOUs with various Banks and Financial Institutions to enable faster delivery of Credit to MSMEs is a unique initiative of our Chamber. We have already entered into such MOUs with Allahabad Bank, Canara Bank, Central Bank of India, Indian Overseas Bank and UCO Bank. MOUs with some other banks are in the pipeline.



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MSMEs, the backbone of Indian Industry

MSMEs are the backbone of the Indian economy in more ways than one. Beginning with its contribution towards providing employment to a large section of the society at a lower cost than larger industries and thus facilitating rural and backward areas industrialisation. MSMEs are a crucial factor in enhancing the socio-economic contribution in the respective domain. There are however, various challenges that MSMEs encounter and the need for them to create a sustainable business model. Further, MSMEs play a complementary role as ancillary units to large industries.

1.1 Definition of MSME

The legal definition of MSME emanates from the Micro, Small and Medium Enterprises Development Act, 2006, the objectives which are to facilitate, promote, develop and enhance the competitiveness of MSMEs. This Sector consists of all kinds of enterprises, viz., proprietorship, Hindu Undivided Family, Association of Persons, Cooperative Society, Partnership or company undertaking or any other legal entity, engaged in production of goods pertaining to any industry specified in the first schedule of Industry Development & Regulation Act, 1951 and other enterprises engaged in production and rendering services, subject to limiting factor of investment in plant and machinery and equipment respectively.

As per the Act, MSMEs are defined as under:

(a) Enterprises engaged in the *manufacture or production*, processing or preservation of goods as specified below:

- (i) A **micro enterprise** is an enterprise where investment in plant and machinery does not exceed Rs. 25 lakh;
- (ii) A **small enterprise** is an enterprise where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore; and
- (iii) A **medium enterprise** is an enterprise where the investment in plant and machinery is more than Rs.5 crore but does not exceed Rs.10 crore.

In case of the above enterprises, investment in plant and machinery is the original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification No.S.O.1722 (E) dated October 5, 2006.

(b) Enterprises engaged in **providing or rendering of services** and whose investment in equipment (original cost excluding land and building and furniture, fittings and other items not directly related to the service rendered or as may be notified under the MSMED Act, 2006 are specified below.

- (i) A **micro enterprise** is an enterprise where the investment in equipment does not exceed Rs. 10 lakh;
- (ii) A **small enterprise** is an enterprise where the investment in equipment is more than Rs.10 lakh but does not exceed Rs. 2 crore; and
- (iii) A **medium enterprise** is an enterprise where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

Manufacturing Classification by investment in plant and machinery)	Services (Classification by investment in equipment)
Micro - <=25 lakh	Micro - <=10 lakh
Small - >25 lakh & <=5 Cr	Small - >10 lakh & <=2 Cr
Medium >5 Cr & <=10 Cr	Medium >2 Cr & <=5 Cr

Recent developments:

The ministry has recommended a revised definition of MSMEs through an amendment of MSME Act. The ministry feels that since the amount was fixed in 2006 and there has been an increase in the price index and the cost of inputs, there is a need to amend the definition. The draft amendment proposal reads as follows:

Manufacturing	Present	Proposed
Micro	Rs. 25 lacs	Rs. 50 lacs
Small	Rs. 5 crore	Rs. 10 crore
Medium	Rs. 10 crore	Rs. 30 crore

Services	Present	Proposed
Micro	Rs. 10 lacs	Rs. 20 lacs
Small	Rs. 2 crore	Rs. 5 crore
Medium	Rs. 5 crore	Rs. 15 crore

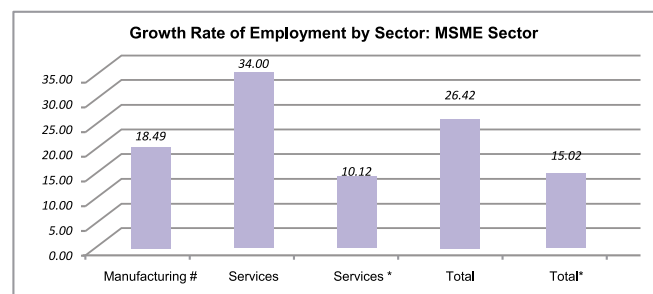
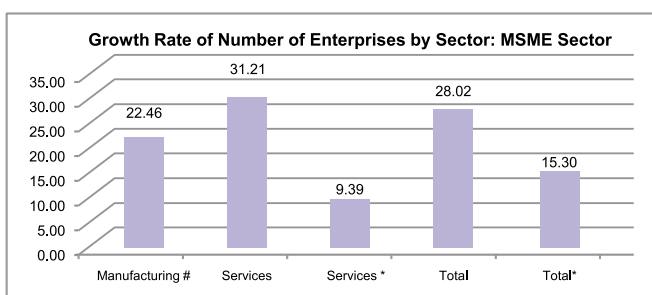
This is in line with the Parliamentary standing committee and RBI committee's recommendations that considering the inflation and dynamic market situation these definitions need to be revised.

1.2 Growth of MSME sector

The growth of MSME sector has significant sympathetic effect on generating huge employment opportunities, using lower capital as compared to larger industries and facilitates industrialisation of hitherto non-industrialised rural areas. It can thus, reduce regional imbalances; provide a more equitable distribution of national income and wealth. The MSME Ministry Annual Report 2013-14 provides a good background of the growth of employment and MSMEs. It is captured in their notes and the graph provided below:

- a) While on a strictly comparable basis, growth rate recorded during the year 2001-02 to 2006-07 was 15.30% and 15.02% for estimated number of Enterprises and Employment respectively. The sector as a whole recorded a growth rate of 28.02% and 26.42% in cases of estimated number of enterprises and employment respectively, taking into account the definitional changes during the period 2001-02 to 2006-07.
- b) As the activities brought under the coverage of MSME sector due to definitional changes in 2006-07 were limited to services sector, the growth rate for manufacturing sector is comparable. The growth recorded during the year 2001-02 to 2006-07 in manufacturing sector was 22.46% and 18.49% for estimated number of enterprises and employment respectively.
- c) For service sector, while the growth rate in estimated number of enterprises and employment recorded was 31.21% and 34.00% respectively, during the period of 2001-02 to 2006-07 taking into account the expanded coverage of the sector, the same was 9.39% and 10.12% respectively on strictly comparable basis.

The graphs below portray the MSME sector growth alongside employment



- In view of the fact that the activities excluded in the coverage pertaining to service sector only, there is no change in growth rate of manufacturing sector

* - Excluding growth on account of expansion of coverage

Source: MSME Annual Report 2013-14

1.3 Significance of MSMEs in the economic growth

The significance of MSMEs in the economic growth is underlined from their capacity to bring in dynamism, resourcefulness and risk taking abilities to sustain the process of economic growth. Due to their potential in augmenting the growth with employment opportunities the MSMEs have received fair degree of policy initiatives in recent past. To cite from the MSME Ministry Annual Report 2013-14, based on the results of Fourth All India Census of MSMEs, the sector contributes significantly to the number of enterprises, employment and output of the country. Further, based on the data sets of Third and Fourth All India Census of SSI / MSMEs, augmented with data sets of EC, 2005 and growth rate observed during Fourth (1998) and Fifth (2005) Economic Census, the performance of SSI/MSME Sector is summarised in the table below.

Performance of SSI/MSME: Employment, Investments

	Year	Total Working Enterprises (in Lakh)		
I	II	III	IV	V
1.	2001-02	105.21	249.33	154,349.00
2.	2002-03	109.49	260.21	162,317.00
3.	2003-04	113.95	271.42	170,219.00
4.	2004-05	118.59	282.57	178,699.00
5.	2005-06	123.42	294.91	188,113.00
6.	2006-07	361.76	805.23	868,543.79
7.	2007-08#	377.36	842.00	920,459.84
8.	2008-09#	393.70	880.84	977,114.72
9.	2009-10#	410.80	921.79	1,038,546.08
10.	2010-11#	428.73	965.15	1,105,934.09
11.	2011-12#	447.66	1,011.80	1,183,332.00
12.	2012-13#	467.56	1,061.52	1,269,338.02

- Including activities of wholesale/retail trade, legal, education & social services, hotel & restaurants, transport and storage & warehousing (except cold storage) for which data was extracted from Economic Census 2005, Central Statistics Office, MOSPI.

- Estimated on the basis of per enterprises value obtained from sample survey of unregistered sector for activities of wholesale/retail trade, legal, education & social services, hotel & restaurants, transports and storage & warehousing(except cold storage) which were excluded from Fourth All India Census of MSMEs, unregistered sector

- Projected.

Source: MSME Annual Report 2013-14

Contribution of MSME (Manufacturing Sector) in the GDP

The contribution of MSME (Manufacturing Sector) in the GDP is an equally significant factor. The MSME Ministry Annual Report 2013-14 states - based on the results of All India Census of SSSI/MSMEs, an attempt has been made to estimate the share of MSME Sector in manufacturing output and GDP. The estimated value of manufacturing output of MSME Sector and its share in total manufacturing output & GDP are as provided in the table below.

Year	Gross Value of Output (Rs. in Crore)	Percentage Share of MSME	
		Total Manufacturing Output	Gross Domestic Product (GDP)
2006-07	1198817.55	42.02	7.73
2007-08	1322960.41	41.98	7.81
2008-09	1375698.60	40.79	7.52
2009-10	1488390.23	39.63	7.49
2010-11	1655580.60	38.48	7.42
2011-12*	1790804.67	37.52	7.28

Note:

* - Provisional.

Source: 1. Fourth All India Census of MSMEs 2006-07,

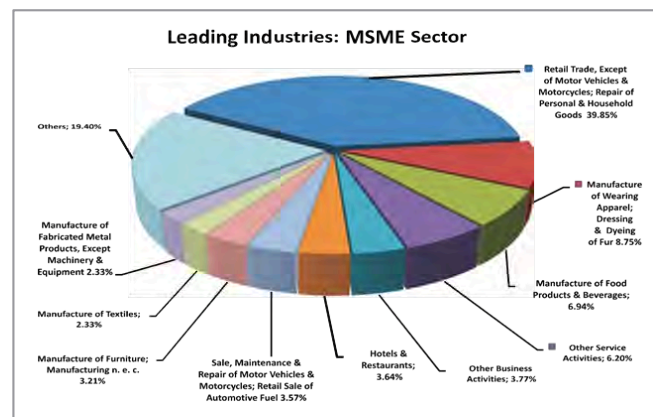
2. National Account Statistics 2013, CSO, MOSPI and

3. Annual Survey of Industries, CSO, MOSPI

Source: MSME Annual Report 2013-14

Spread over large number of industries

Due to its very nature of business, MSMEs provide the maximum opportunities for both self-employment and jobs after agriculture sector. Again, there are around 6000 products spread over a large number of industries ranging from traditional to high-tech items, which are being manufactured by the MSME sector besides providing wide range of services. The leading industries with their respective shares are as depicted below:



Source: MSME Annual Report 2013-14

In sum, the sector accounted for a significant proportion of manufactured output of our GDP. In addition to their strong export orientation, they have a strong employment potential, providing bread and butter to nearly 100 million people, next only to the agricultural sector. With a big chunk of them being located in rural areas, it also offers tremendous potential for rural development. Given their forward and backward linkages with the corporate sector they are engines of growth, especially in slow economic cycles.

2

MSMEs challenges and the initiatives from Government of India

MSMEs face challenges on various fronts, be it finance, marketing, financial transparency and guidance. These challenges arise partly from their size and the traditional outlook of the lenders.

a) **Timely flow of credit** - The working capital management for MSMEs proves to be more difficult considering the manner in which they run their businesses; working capital limits provide some support to these enterprises in managing their cash conversion cycles. Factoring of their receivables would help reduce their burden.

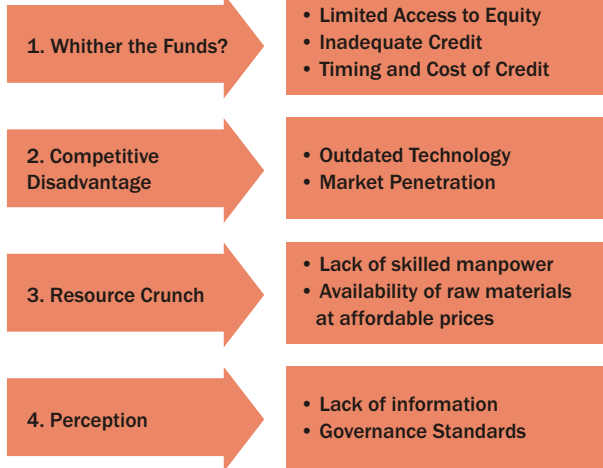
b) **Rising debt burden** - Increasing rates have seen high interest costs borne by MSMEs. Their financing charges are reflective of the banker's perspective of the segment. The setting up of an SME Credit Bureau which enables information pooling and sharing could reduce the riskiness of lending to this sector, allowing bankers to reduce their charges.

c) **Information required by banks for lending** - Most micro enterprises find it difficult to provide the information sought by banks due to a lack of understanding on the financial reporting formats designed. Financial literacy programs targeted at these enterprises could help them understand these requirements better.

2.1 Challenges faced by MSMEs

One of the key ingredients for success of the MSMEs is to create a long-term sustainable business model. To be continuously viable in the marketplace, the MSMEs should be able to continuously innovate and meet the customer requirements, be profitable, and manage the changing environment. To enhance their creditworthiness, the MSMEs should be able to address the perspectives of Credit Rating Agency, concerns of the lenders & investors.

Numerous studies have documented that, given the lack of reputation and tangible collateral, debt financing, mostly from informal sources, comprise the primary source of external funds for these entities. Given the often onerous documentation requirements for banks, these entities tend to get a raw deal when it comes to bank finance. The Fourth Census of MSME revealed that only 5.2 per cent of the units (both registered and unregistered) had availed of finance through institutional sources; the majority of units - 93 per cent of them in fact - had either no finance or depended on self-finance. Many surveys reinforce these conclusions. The moot point is that the credit flow to MSMEs from institutional sources is not commensurate with the economic activity undertaken by them.



There are challenges and adaptable mitigants for these. Some of the illustrative lists are provided below.

Fund raising

i. Access to Equity

Market shocks such as rising inflation and falling demand are best weathered by the infusion of capital in businesses; the limited access to both private equity and capital markets by MSMEs continues to pose a challenge to their operating environment. However, some of the initiatives undertaken can mitigate them to a large extent. For instance,

- The Union Budgets of recent years proposed India Opportunities Venture Fund with SIDBI to enhance the availability of equity to the MSME sector.
- Simplification of listing guidelines for SMEs by SEBI
- Introduction of SME Exchange Platforms on NSE and BSE

ii. Access to Credit

Financial inclusion allows for equitable growth. Financial inclusion makes growth broad based and sustainable by progressively encompassing the hitherto excluded population. With the Reserve Bank of India's thrust on financial inclusion backed by policy decisions taken at the MSME ministry level, the bank credit to MSMEs has risen over the last few years. There is ample scope for further credit to be provided to MSMEs as many MSMEs do not have access to any form of credit currently. Rising interest rates have added to the burden of the sector already plagued by lesser access to credit.

A number of directives issued by the Reserve Bank of India have helped move more credit towards the sector like removal of collateral requirements, benign provisioning norms for advances to MSMEs, targeted growth for bank advances to micro enterprises. It should be noted that

while banks have reported higher disbursement of credit to MSMEs, the cost of credit is still high for the sector as they are traditionally believed to be a high risk segment to lend to.

A RBI Discussion Paper in 2013 had propounded an innovative combination of banks and private equity, with a potential role of state in providing credit enhancement mechanisms/ solutions as a way out of this credit constraint. It also put forth the proposal that small banks can provide a useful role by catering to the needs of this segment, for example, through relationship banking.

Competitive Disadvantage

• Outdated Technology

While globalisation has helped open different markets to players, it has also increased competition among different countries. The performance of the sector is highly linked to the management of costs which in turn depends on the technology that is used. Most MSMEs currently operate on obsolete technology rendering them highly uncompetitive in their industries. These include textiles, agro chemicals, apparel etc. It is necessary to adapt global practices to Indian scenario and upgrade the technology matters without upsetting the operations and cash flow. The MSME ministry seeks to address this concern by its International Cooperation Scheme which allows for -

- Deputation of MSME business delegations to other countries for exploring new areas of technology infusion/upgradation, facilitating joint ventures, improving market of MSMEs products, foreign collaborations, etc.
- Participation by Indian MSMEs in international exhibitions, trade fairs and buyer-seller meets in foreign countries as well as in India, in which there is international participation.
- Holding international conferences and seminars on topics and themes of interest to the MSME.

The Technology Upgradation Financial Scheme extended in the Union Budgets combined with the Micro-Small Enterprises Cluster Development programme are aimed at enabling MSMEs to upgrade the technology they use.

• Market Penetration

Most entities in this sector are dependent either on many players in the fragmented sector or on one or two major customers; thus, their performance is irrevocably tied to the performance of the economy as a whole. Pricing powers too are absent in such scenarios thus forcing them to meet rising costs on their own.

The Public Procurement Policy mandates PSEs to procure a minimum of 20% of their total purchases from the MSME sector helps bring in some revenue stability for the segment.

Resource Crunch

• Lack of Skilled Manpower

A lack of available skill sets especially in an environment where technology changes are frequent can lead to a reduction in efficiency in the system. Training becomes essential for these units as they begin to move towards improvisation in technology.

Still, significant efforts are needed for skill and entrepreneurship development. In addition to these, the industry must contribute to building up a large base of appropriately skilled workforce available for employment in MSMEs through training programmes by the industry associations to upgrade the skills compatible with the new technology. There is still a lack of awareness among many enterprises due to which their skill sets are still outdated rendering people in these companies unemployable in the long run. The Government of India and various State governments have started programs for skill development.

• Availability of raw material at affordable prices

The profit margins of MSMEs are highly susceptible to raw material price movement. Their small size prevents them from having a say in the pricing of their supplies, thus exposing them to risks arising from rising inflation, rupee volatility, low supply as well as increasing transportation costs. Their size also sometimes prevents them from passing on their increasing costs, thus making their operations unviable. The government agencies are using their offices to redress these problems.

Perception

• Lack of Information

Most of the challenges related to funding an MSME are tied to the lack of information that is perceived to exist for MSMEs. The unorganised nature of the segment makes it difficult to obtain auditable and reliable information rendering challenges faced by this segment further tough to meet. This is further exacerbated by a lack of understanding on the part of the entity on what information is most relevant to be shared with lenders and other agencies as well as the format in which the same needs to be provided. Lenders take decisions on the payment track record of borrowers, MSMEs that are not present in a credit bureau's database can reduce the chances they have to being lent to due to a lack of this information.

However, it should be noted that different industry bodies, ministries and regulators capture data on this segment to some level; this data is mainly incomparable due to a difference in definition and timing of collecting of the data. A task force that can look at combining the data available to store all such information in a common database would address some of the concerns regarding unavailability of information in this segment.

• Governance Standards

Concerns on the quality of governance and accounting standards continue to plague this sector. SIDBI is addressing this issue by providing various templates for MSMEs to use, viz. Business Plan, Financial Projections, Financial statements etc. Financial literacy programmes need to be run to update the enterprises on changing guidelines and standards in their sectors. The perception of most lenders in this segment is that diversion of cash flows and credit to other businesses etc. is a substantial risk; however, only some firms that indulge in such practices. A bank that takes the time to educate the customer on the necessity to manage personal cash flows separately from the cash flows arising from their business will be better placed to manage such risks.

Bankers often complain that MSMEs are often quite lackadaisical when it comes to settling their dues. The main reason is that, MSMEs often act as ancillaries to large industries, and their cash flows are lumpy. The business orientation of large industries often affects the MSMEs directly, in turn hampering the recycling of funds and business operation of MSME units. Banks need to take a proactive view, carefully analysing the linkages of the MSME units, when sanctioning funds. The existing provisions of the Interest on Delayed Payment Act, 1998 for these entities have been suitably modified taking on board their unique characteristics. In addition, banks have been advised to sanction separate sub-limits within the overall limits sanctioned to the corporate borrowers for meeting payment obligations in respect of purchases from MSME sector. The Parliament has passed the Factoring Regulation Bill that is expected to address delays in payment and liquidity problems of micro and small enterprises. These measures will contribute in no small measure towards alleviating the extant constraints that plague this sector.

2.2 Policy Initiatives from MSME Ministry

The union government and the state governments play a complementary role in promotion and development of MSMEs. MSME ministry supplements the efforts of the state governments through various initiatives in encouraging entrepreneurship, employment and livelihood opportunities and enhance the competitiveness of MSMEs in the changed economic scenario with initiatives in facilitating and providing:

- i) adequate flow of credit from financial institutions/banks;
- ii) support for technology upgradation and modernization;
- iii) integrated infrastructural facilities;
- iv) modern testing facilities and quality certification;
- v) access to modern management practices;
- vi) entrepreneurship development and skill upgradation through appropriate training facilities;
- vii) support for product development, design intervention and packaging;
- viii) welfare of artisans and workers;
- ix) assistance for better access to domestic and export markets and
- x) cluster-wise measures to promote capacity building and empowerment of the units and their collectives.

The ministry has been pro-active in launching initiatives to bolster the sector through implementation of the MSMDA, 2006 and other measures. Acknowledging the challenges faced by the MSME sector, some of the initiatives are given below:

- Reservation /De-reservation of products for manufacture in the MSE Sector
- National Manufacturing Competitiveness Program (NMCP)
- Public Procurement Policy for goods produced and services rendered by MSEs
- Enhanced Credit Flow to the MSE Sector

- Credit Guarantee Scheme
- Micro & Small Enterprises Cluster Development Program (MSE-CDP)
- Technology Centre Systems Program (TCSP)
- Credit Linked Capital Subsidy Scheme
- Entrepreneurship and Skill Development
- Performance and Credit Rating Scheme

National Board for MSMEs The Government has set up for the first time, a statutory National Board for MSMEs so as to bring together the representatives of different sub-sectors of MSMEs, along with policy-makers, bankers, trade unions and others - in order to move towards cohesive development of the sector. The Board meets periodically and the deliberations and directions of the National Board pave the way to guide and develop enterprises in this sector - to become more competitive and self-reliant.

2.3 RBI Steps for expanding credit to MSMEs

As part of meeting the challenges in credit front, RBI wants increased flow of credit for the MSME sector. Despite continuous increase in the bank credit for the MSME sector, the formal credit flow for this sector is very meagre compared to the enormous number of units in this sector and the banking sector should tap the great potentials of this sector. The biggest hurdles facing the banking system are:

- its requirements of documentation,
- its traditional models of assessing the credit needs of the MSMEs and
- the gap in the attitude and sensitivity of the bank officials.

Many observers feel that NBFCs have found a balanced answer to skirt around these hurdles and their flow to this sector has recorded good growth in recent times. It is hoped that, the banking sector can also find such a balance.

Status of lending by banks to this sector

Bank loans up to Rs.5 crore per borrower / unit to Micro and Small Enterprises engaged in providing or rendering of services and defined in terms of investment in equipment under MSMD Act, 2006 are eligible to be reckoned for priority sector advances. Lending to Medium enterprises is not eligible to be included for the purpose of computation of priority sector lending. Detailed guidelines on lending to the Micro, Small and Medium enterprises sector are available in RBI Master Circular July 1, 2014 and updated in July each year.

Targets prescribed for lending by banks to MSMEs

As per extant policy, certain targets have been prescribed for banks for lending to the MSE sector. In terms of the recommendations of the Prime Minister's Task Force on MSMEs, banks have been advised to achieve a 20 per cent year-on-year growth in credit to micro and small enterprises, a 10 per cent annual growth in the number of micro enterprise accounts and 60% of total lending to MSE sector as on preceding March 31st to Micro enterprises.

In order to ensure that sufficient credit is available to micro enterprises within the MSE sector, banks have to ensure that:

- (a) 40% of the total advances to MSE sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs. 10 lakh and micro (service) enterprises having investment in equipment up to Rs. 4 lakh ;
- (b) 20% of the total advances to MSE sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs. 10 lakh and up to Rs. 25 lakh, and micro (service) enterprises with investment in equipment above Rs. 4 lakh and up to Rs. 10 lakh. Thus, 60% of MSE advances should go to the micro enterprises.

Specialized bank branches for lending to the MSMEs

Public sector banks have been advised to open at least one specialized branch in each district. The banks have been permitted to categorize their MSME general banking branches having 60% or more of their advances to MSME sector, as specialized MSME branches for providing better service to this sector as a whole. As per the policy package announced by the Government of India for stepping up credit to MSME sector, the public sector banks will ensure specialized MSME branches in identified clusters/centres with preponderance of small enterprises to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. Though their core competence will be utilized for extending finance and other services to MSME sector, they will have operational flexibility to extend finance/render other services to other sectors/borrowers.

Working capital requirements of borrowers

The banks have been advised to put in place loan policies governing extension of credit facilities for the MSE sector duly approved by their Board of Directors. Banks have, however, been advised to sanction limits after proper appraisal of the genuine working capital requirements of the borrowers keeping in mind their business cycle and short term credit requirement. As per Nayak Committee Report, working capital limits to SSI units is computed on the basis of minimum 20% of their estimated turnover up to credit limit of Rs.5crore.

Recent developments and other initiatives

Trade Receivables and Credit Exchange

RBI has recently taken the initiative of mooted a Trade Receivables and Credit Exchange for financing of MSMEs, which is under development stage. The exchange will bring together the MSMEs, the Factors and the corporate buyers under one platform whereby MSME's bills against large companies can be accepted electronically and auctioned so that MSMEs are paid promptly. The objective is to build a suitable institutional infrastructure which will not only enable an efficient and cost effective factoring / reverse factoring process to be put in place, but also ensure sufficient liquidity is created for all stakeholders through an active secondary market for the same. This system will bring together the MSMEs, their corporate buyers as well as financiers and reduce the constraints faced by the MSME segment in liquidity management.

Sick units

The empowered committees on MSMEs set up at the RBI's regional offices have been asked to closely monitor and review the progress of restructuring / rehabilitation of sick MSE units to help in early detection of sickness in MSE units and their timely revival.

Structured Mechanism for monitoring the credit growth to the MSE sector

In view of the concerns emerging from the deceleration in credit growth to the MSE sector, an Indian Banking Association led Sub-Committee under Shri K.R. Kamath was set up to suggest a structured mechanism to be put in place by banks to monitor the entire gamut of credit related issues pertaining to the sector. Based on the recommendations of the Committee, banks have been advised to:

- strengthen their existing systems of monitoring credit growth to the sector and put in place a system-driven comprehensive performance management information system (MIS) at every supervisory level (branch, region, zone, head office) which should be critically evaluated on a regular basis;
- put in place a system of e-tracking of MSE loan applications and monitor the loan application disposal process in banks, giving branch-wise, region-wise, zone-wise and State-wise positions. The position in this regard is to be displayed by banks on their websites; and
- monitor timely rehabilitation of sick MSE units. The progress in rehabilitation of sick MSE units is to be made available on the website of banks.

2.4 Facilitating alternative funds access by SEBI

Based on the need and the type of requirements, SEBI has introduced various measures in supporting the growth of MSMEs. These steps include, in the recent past to enable Start-ups and SME to raise funds through various routes such as SME Segment of Exchanges, Institutional Trading Platform (ITP), Category I- SME Fund under AIF Regulations.

SEBI has specified framework for a SME segment (platform) on Recognized Stock Exchanges, where SMEs can list their securities. Various relaxations have been provided to SMEs listing on SME segment under SEBI (ICDR) Regulations, 2009. Some of them are:

- Draft Offer document may be filed directly with the exchange and not necessarily with SEBI.
- Eligibility criteria for an issuer under Regulation 26 is not applicable to companies listing under SME segment.

Similarly, relaxations have also been provided with respect to the continuous listing requirements for Companies listed in SMEs:

- Requirement to file half yearly financial results instead of quarterly
- Exemption from publishing financial results in newspaper
- SME companies may send abridged annual report to their shareholders. However, the same need to be displayed on the website of the exchange and company.

In addition to the visibility to SMEs, this framework also provides a trading platform for the scrips of Start-up Companies held by Alternative Investment Funds (AIFs), VCFs etc. and enhances the liquidity in such scrips, which in-turn provide enabling environment for SME and start-up enterprises to flourish.

SME Funds:

An investment fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange may get itself registered as an SME Fund. Such funds:

- shall invest at least 75% of the investible funds in unlisted securities or partnership interest of venture capital undertakings or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange
- may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under Chapter XB of the SEBI (ICDR) Regulations, 2009

Some of the initiatives which have seen good traction are:

a. Simplified process of raising funds in the market has seen many companies using the IPO mechanism to raise funds. An illustrative list of funds raised from the SME platform is provided below:

Year/ Month	Total	
	No. of issue	Amount (Rs crore)
1	2	3
2012-13	24	239
2013-14	37	317
2014-15\$	21	180

\$ indicates as on September 30, 2014.
Source: SEBI

b. SEBI has floated a Consultation Paper on Crowdfunding in India which also covers the extant legal structure governing the fund raising for start ups and SMEs in India. This paper proposes framework for ushering in crowdfunding by giving access to capital market to provide an additional channel of early stage funding to Start-ups and SMEs and seeks to balance the same with investor protection.

In India, during the last few years, the IPO market has not been very active. Though, SEBI, has been at the forefront in facilitating fund raising by SMEs through measures like SME segment in Stock Exchanges, Category I- SME funds under AIF, Institutional Trading Platform, etc., still there is need to encourage innovative way of fund raising to provide an impetus to genuine SMEs/Start-ups and to explore other alternative models of fund raising with appropriate framework in consonance with retail investor protection.

2.5 Role of NSIC

National Small Industries Corporation Ltd. (NSIC), is an ISO 9001:2008 certified Government of India Enterprise under MSME Ministry with vast network of offices and Technical Centres spread across the country. Its mission is to:

- promote, aid and foster the growth of small industries and
- industry related MSMEs in the country.

To achieve its mission, it has:

- promoted modernisation,
- provided impetus to upgradation of technology, quality consciousness,
- strengthened linkages with large medium enterprises and enhancing exports – projects and products from small enterprises.
- set up Training cum Incubation Centre & with a large professional man power;
- provided a package of services as per the needs of MSME sector.
- a set of specially tailored schemes comprising of marketing, credit & technology support and other support services designed to put MSMEs in a competitive and advantageous position.

The NSIC Annual Report 2013-14 provides a glimpse of some of its support to MSMEs. They are:

- NSIC serviced the raw materials requirements of MSMEs by supplying Iron & steel allocated through Ministry of Steel, Aluminum from NALCO & BALCO, Paraffin Wax from CPCL & IOCL, Coal from Coal India Ltd., and Polymer Products i.e. PP, HDPE & LLDPE from IOCL. Copper material from Sesa Sterlite has been added to the Raw Material Distribution during the year 2013-14.
- Credit support of Rs. 4,84,321 lac was provided for Raw Material Procurement to MSMEs against Rs. 4,14,834 lac during the previous financial year, registering growth of 17%.The total raw material distribution was to the tune of 8,74,266 MT as against 7,83,309 MT during last financial year, registering a growth of 12%. In addition to this, the Corporation opened six distribution Centres for supply of raw material during 2013-14 in addition to the existing 77 distribution centres.
- The Portfolio of Bank Guarantee for providing credit support reached to Rs. 2,59,574.59 lac on 31st March, 2014 as against Rs. 2,06,858.40 lac on 31st March, 2013, thereby registering a growth of 25%.
- The credit facilitation of Rs. 5,18,559.71 lac was made during the year to Micro, Small & Medium Enterprises as against Rs. 4,39,202.23 lac during the previous year registering a growth of 18%.
- Performance & Credit Rating Scheme for Micro & Small Enterprises, wherein 24,886 units were rated during the year as against the target of 20,000.
- Marketing Assistance Scheme, wherein 1,021 events were held / participated (including nine international level exhibitions organised) to support marketing efforts of MSMEs under this scheme.

Besides above, amongst other things, NSIC holds International Trade Fair, Techmart exhibition wherein MSMEs from all over India showcase their products and technologies, which provides

a comprehensive view of opportunities in terms of marketing or creating sustainable business alliances in this sector.

In sum, the improvement of access to banking facilities is also a primary concern of the NSIC which introduced the Performance and Credit Rating Scheme. Under this scheme, NSIC pays 75% of the rating fees to the rating agency while the company pays 25% of the fees. The availability of an external rating helps to improve the transparency of the MSME rated; most banks tend to lend at lower rates to a company rated under this scheme than to an unrated entity in the sector.

2.6 Other initiatives

The MSME sector gets a fair deal of attention of the government and gist of some of the proposals is:

- MSME have a large share of jobs, production and exports. Too many of them do not grow because of the fear of losing the benefits associated with staying small or medium. To encourage them to grow, the benefits or preferences enjoyed by them will now stay with them for upto three years after they grow out of the category in which they obtained the benefit. To begin with, the non-tax benefits would be made available to an MSME unit for three years after it graduates to a higher category.
- To provide greater support to MSMEs, the refinancing capability of SIDBI has been enhanced from Rs.5,000 crore to Rs.10,000 crore per year.
- The SIDBI set up the India Microfinance Equity Fund in 2011-12 has received additional budgetary support.
- The Factoring Act 2011 has been passed by Parliament.
- A provision of a corpus to SIDBI has been made to set up a Credit Guarantee Fund for factoring.
- Tool Rooms and Technology Development Centres set up by the MSME Ministry have done well in extending technology and design support to small businesses.
- Further, with World Bank assistance, additional Centres are proposed to be set up.
- Incubators play an important role in mentoring new businesses which start as a small or medium business.
- The new Companies Act obliges companies to spend on CSR. The Ministry of Corporate Affairs has notified that funds provided to technology incubators located within academic institutions and approved by the Ministry of Science and Technology or Ministry of MSME will qualify as CSR expenditure.
- Skill India to be launched to skill the youth with an

emphasis on employability and entrepreneur skills.

- Committee to examine the financial architecture for MSME Sector, remove bottlenecks and create new rules and structures to be set up and give concrete suggestions.
- Fund of Funds with a corpus of Rs. 10,000 crore for providing equity through venture capital funds, quasi equity, soft loans and other risk capital specially to encourage new startups by youth to be set up.
- Corpus of Rs. 200 crore to be set up to establish Technology Centre Network .
- Definition of MSME to be reviewed to provide for a higher capital ceiling.
- Programme to facilitate forward and backward linkages with multiple value chain of manufacturing and service delivery to be put in place.
- Entrepreneur friendly legal bankruptcy framework will be developed for SMEs to enable easy exit.
- A nationwide “District level Incubation and Accelerator Programme” to be taken up for incubation of new ideas and necessary support for accelerating entrepreneurship.

Appropriate action has been initiated by the concerned government bodies for implementation of these announcements.

Launch of MSME Virtual Clusters

An Initiative of MSME Ministry, virtual Clusters conceived as supplementing Physical Clusters, is a dedicated Web-portal which will enable the small businesses located anywhere in the country as well as the other stakeholders; Banks and other financial institutions; Central State and other Government bodies; NGO, Industry Experts, Consultants and trainers; Academia; Research & Technical Institutions etc. to register instantly thereon and avail prompt linkages with each other. This Web-platform would facilitate the stakeholders to leverage the expertise of each other for their mutual growth and benefit. The web portal would be administered by the National Institute for Entrepreneurship and Small Business Development (NIESBUD), an organization of the Ministry of MSME.

Inter-Ministerial Committee for Accelerating Manufacturing in MSME

An Inter-Ministerial Committee for Accelerating Manufacturing in MSME was set up under the Chairmanship of Secretary (MSME). The Committee has made a number of recommendations covering issues of regulation, finance, infrastructure, technology and market through the different stage of the life cycles of MSMEs.

An illustrative list of companies raising funds through IPO (SME) platform during September 2014

Sl. No.	Name of the Issuer/Company	No. of Shares Issued	Face Value (Rs)	Premium Value (Rs)	Issue Price (Rs)	Size of Issue (Rs crore)
1	Naysaa Securities Limited	10,00,000	10	5	15	2
2	Sirohia & Sons Limited	30,00,000	10	2	12	4
3	Encash Entertainment Ltd	10,98,000	10	30	40	4
4	Ultracab (India) Ltd	22,14,000	10	26	36	8
5	Atishay Infotech Limited	23,20,000	10	6	16	4

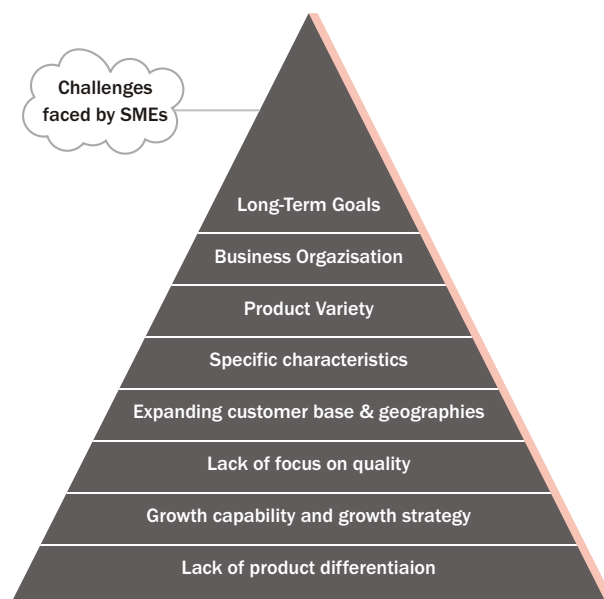
Source: SEBI Bulletin

Enhancing creditworthiness through credit rating

3.1 Creating a Sustainable Business Model

Small and Medium Enterprises (SMEs) have been playing a very crucial role in the economic growth of our country. This is well recognised, considering their contribution in achieving a variety of objectives of national importance, such as inculcating a spirit of entrepreneurship, employment generation, contribution to industrial output and exports. The depth they provide to the industrial base and services sector of the country's economy is also well recognised. SMEs use natural resources / local skills and help for balanced development of Regions. They facilitate shift from agricultural economy to industry and services sector, and helps lowering migration from rural and semi urban areas to urban and metropolitan cities.

In this chapter, we examine the challenges to creating a Sustainable Business Model for the SMEs, and try to come out with solutions.



3.2 Sustainability:

According to the dictionary meaning, "Sustainability is the ability to maintain or support an activity or process over the long term or the ability to endure and survive in an environment into the future." **The words 'long term' and 'to endure and survive' are the key words here.** While the 'present' may be fine and serving its purpose, whether the activity will continue to be viable considering the continuous changes that keep happening in the business environment, is the issue. That means, the business should be able to continuously innovate to meet the customer requirements, be profitable, and meet the new regulations that they may encounter - for example,

changes in labour laws, environmental concerns, etc. Businesses should continue to grow, and stagnation is death. Therefore, we should look at challenges for growth, both in revenues, profitability, and ability to meet the requirement of stake-holders. We can analyse them in the context of business organization, products, quality and customer satisfaction, and financial soundness.

3.2.1. To operate a financially sustainable business, entrepreneurs need to develop long term goals that outline where they want their business to stand financially in the future. The profit to be made, the level of debt and cash flow requirements all need to be taken into consideration. Developing a well thought-out plan will help firms to arrive at this position within a specified time frame.

A business that is not financially sustainable will not be able to survive in the market for long. Eventually, all of its savings will be used up and there will be no assets to sell to cover the expenses. This is what makes financial sustainability such an important part of managing a business successfully now and into the future.

3.2.2. Business Organization - Ownership Structure Most SMEs in India are proprietorship or partnership concerns, run by a single person, or just family members.

As per MSME Annual Report 2011-12, more than 90% of MSME enterprises are proprietorship concerns. While this is fine when the business is initiated, there is a need to change this. For example, if the top-line crosses Rs. 5 crores, there is definitely a need to broad-base the ownership, and move in to the next step, viz., 'partnership'. The partners could be family members or other close associates. Each partner should bring something to the table, and should be complementary. To illustrate, if one could take care of product development or manufacturing, another can take care of marketing, and the third finance and administration. Limited Liability Partnerships, which are now available in our statute book could also be made use of. As the business volume grows further, corporatization should be the goal. This makes the business entity more attractive to investors and lenders, apart from ensuring continuing despite retirement or death of individuals. Many SMEs are reluctant to take this route, thinking that the original entrepreneur loses control over the unit. There are many ways of addressing such concerns, and SMEs should take professional help in taking such decisions.

3.2.3. Product Development Most SMEs have either a fixed product or service, or little variety in what they offer. While this product could be very successful or popular and brings in the initial growth, a stage will come, when the

business starts stagnating. The business should invest in whatever measure that is possible, in product innovation. They should be alive to research and development that is happening in their area, changes in customer preferences, and further diversification that is possible just to generate more revenues. If we just look at the way family jewelers who used to work on customer orders have now moved to stocking a variety of pieces, so that the customer buys what he sees, is a good example.

These products/services are centered around one or more segment of customers to whom they cater to. A majority of SMEs operate from only a single geographical location and to customers in their or nearby regions. They have few suppliers and are basically industry-centric on the whole in a business perspective. In short, most of SMEs are single man show, with single product or service, to a single customer covering a limited or single geographical location.

3.2.4. Specific characteristics of SMEs in India:

- Ownership typically restricted to few individuals. Often there is family ties between the promoters.
- Low capitalisation and limited resource availability
- Lack of professional management
- Lack of credit information
- Poor financial disclosures on account of tax issues
- Directed lending based on RBI guidelines
- Poor access to capital markets
- High risk perception leading to high borrowing cost
- Lack of proper understanding of the international trade policies.

3.2.5. Ability to expand Customer Base and enlarge Geographies There are a large number of SMEs who have severe customer concentration. Their reaction is that this customer has been good, supported them over a period of time, and hence, they do not want to take the risk of expanding customer base. This is particularly seen among component suppliers, in engineering and auto industries, or those who work for some Government Departments or Undertakings like Railways, Electricity Boards, etc. This attitude is risky, and the entrepreneur should not put all his eggs in one basket. At the earliest stage, the business should try to diversify the customer base. Even geographical concentration, wherever feasible, should be minimized.

3.2.6. Quality consciousness One complaint against SMEs is their lack of focus on quality. One reason could be lack of investment in testing or quality control infrastructure. In the long run, it is only the quality conscious customer who wins, and hence, this investment should not be ignored. Where feasible, a cluster approach can be followed, with entrepreneurs joining hands and setting up common facilities for such purposes, In Cluster approach SMEs can access information, knowledge skills and finance, have linkage with markets and suppliers. It will help to increase innovation, joint learning and collective efficiency.

3.2.7. Capacity Expansion & Reaching Geographies The environment in which most enterprises operate is very competitive and the only way to beat the competition is by adding value in a different way to the enterprise's product

or service. The two primary issues concerned are: growth capability and growth strategy. Growth capability refers to a firm's infrastructure. Growth strategy refers to that business plan that a firm desperately needs to have in place. Unless both of these issues are covered, long-term growth will be impossible.

With growth capability, the firm's production capacity and introduction of new products/services or additions to product lines comes into the picture. The decisions regarding these factors are crucial in the enterprise's future viability. An enterprise's growth strategy revolves basically around the enterprise's expansion plans to new locations/ geographies which although will help in achieving in revenue diversification / segmentation but will also affect the enterprise in the long tem.

3.2.8. Product differentiation It is a critical strategic marketing process. A differentiation strategy is key to building competitive advantage. Businesses need to continually differentiate their products from their competitors. If there is no differentiation, why would a customer buy a product from an enterprise compared to a competitive product? As a small business owner, one needs to know that the need to build products or services with unique value or unique competitive advantage. However, fairly quickly, competitors will copy, or even improve upon an entrepreneur unique values or advantages, and therefore the advantage is soon lost. Most highly valued attributes become commodity features over time. To combat that loss of advantage or uniqueness, a business needs to be continually developing new value and benefits in existing products or services and/or developing new products and services to remain in a market leader position.

3.3 The need for being competitive:

3.3.1 Price competitiveness One of the processes that make the business keep going is pricing. Determining how to price goods and services is the key for an enterprise to earn big. But there is also the aspect where the competition arises. Of course, if an enterprise wants to gain lots of income, it will price their goods a little bit higher. But if they have a nearby competitor, the pricing strategy will be changed just to capture the attention of the potential customers. This is now where the competition arises thus, affecting your business. One of the results of the competition is fluctuation. In this event, the supply and demand relationship is compared to a seesaw because as the one increases, the other one lowers in value. So, if a business has several competitors offering the same goods or services, the lower the price will be. Conversely, fewer competitors in the area means the price of the firm's goods will be higher.

3.3.2 Cost competitiveness Cost competitiveness is a business strategy that allows an enterprise to become the lowest cost production firm in an industry. Traditionally, businesses have two options for improving profits: increasing sales or decreasing costs. Cost competitive strategies focus on acquiring raw

materials that are the highest quality at the lowest price. Business owners must also use the best labor to transform raw materials into valuable consumer goods. Low-cost strategies such as these usually translates into high-quality goods at low consumer prices. The ability to undercut a competitor's price often leads to increases in market share and overall profits for enterprises.

However, having the lowest costs is not a guarantee of market success. We see cost competitiveness as a level of operation that allows an organization to go on winning sales at a price that generates a sufficient level of return both for the entrepreneur and for the investment needs of the business. The consideration of cost competitiveness starts in the market with pricing. Winning market share through dropping price is only sustainable if the cost structure can sustain this. To get pricing right, the firm must identify the actual costs involved in supplying the service or product – right across the enterprise. Efficiency is important as well ,there shouldn't be any wastage of resources but not all spending is bad. Budgets can be too low, and resources too meager to meet the demands of the market , hence the costing for an enterprise must essentially stay competitive yet practical.

3.3.3 Competitiveness in Quality and Service In the midst of a heavy competition, lower prices are being developed through incorporating added value or quality to services or products. This is also used as a pricing strategy. This approach is also used when external factors happen such as recession. Since products and services produced by different enterprises have different quality or level of service, their prices also range from one another. With this, enterprises can position the goods and services at various price ranges basing to what the competitors' price ranges are and the level of quality offered.

3.3.4 Aligning business models with changing economic environments With the ever changing economic environment, the needs of customers as well as suppliers keep changing and it is very essential and crucial for businesses to be in line with these changes as the supplier-customer relationship is of prime importance to an enterprise. Business sustainability is closely linked to economic stability and market growth. If one of the customers or suppliers find themselves in difficult economic conditions, it could have an impact on the enterprise as well. Improved technology, communications and distribution channels have changed the number of participants and physical distances between partners in the supply chain. This means that the sustainability of any single organisation can now have an impact on the sustainability of the other participants in the supply chain. Considering these factors, there is a huge need for aligning the business model of an enterprise with the changing economic environments according to the needs of a customer and/or supplier and this can only be done through business model innovation.

Business model Innovation is a process that involves coming up with new ideas, products and solutions and changes in a business model of an enterprise that meet the needs of the market. It can also be used as an internal business process to improve your systems and processes. Innovation can help a firm to remain up to date and competitive in the marketplace.

Most products and services have a useful lifecycle, after which they become superseded, irrelevant or are made redundant by new products and services. Without innovation, a business will only survive as long as the products and services it offers are still valued in the market. New ideas and solutions need to be generated to solve problems to ensure that a business doesn't get left behind as the market advances.

For a business to remain sustainable, it needs to be able to compete with other businesses for the opportunity to sell to consumers. Businesses that offer innovative products and services are able to differentiate themselves from the competition and attract or maintain a share of the market. Sustainable market share is crucial to the long term viability of your business.

Innovation can also lead to new opportunities in industries that have potential for strong future growth. For example, the renewable energy sector which just a few years ago, there was very little money invested in this industry and few opportunities to generate a profit, however, with the increased attention now placed on environmental sustainability, it is a viable option that many organizations are capitalising on.

In today's increasingly complex environment, business model innovation can be critical to organizational success.

Not every organization needs to innovate its business model immediately, but the capabilities need to be established in order to act when the time is right. These capabilities such as alignment with customer/supplier values, analytical insight and an adaptable operating model can improve the execution of business model innovation of an enterprise.

Business model innovation should be looked at as an investment that will help to secure the long term sustainability of a business. The resources and effort that are put into the innovation process now will continue to repay the business as time goes on.

Sustainable development is absolutely vital, but must be balanced against longer-term economic issues. Technologies are major levers and base for further sustainable development.

3.2 Raising The Level of Management Standards

Important considerations include strengths and weakness of key members of management, depth and stability of top management, and recent and prospective management changes. Management strategies are also a material determinant in differentiating firms and in establishing a company's business profile. The assessment also encompasses financial policies, corporate goals, strategies, tactics, and plans for both regulated and diversified businesses, as well as analysing how effectively they are implemented.

The assessment of management is based on such factors as tenure, industry experience, a grasp of industry issues, and knowledge of customers and their needs. Management's ability and willingness to develop workable strategies to address its system's needs, to execute reasonable and effective long-term plans, and to be proactive in leading its company into the future are assessed. Thoughtful balancing of any public and private priorities, a record of credibility, and effective communication also indicate management quality with the public, regulatory bodies, and the financial community.

Key financial policy considerations include management's ability to achieve cost-effective operations and, of utmost importance, management's relative commitment to credit quality. Evaluating accounting and financing practices, and capitalization and common dividend objectives can assess this. The company's philosophy regarding growth and risk taking incorporates a discussion of diversification plans:

- What type of exposure will the company accept in terms of business risk and sovereign risk if it is expanding geographically?
- Will it limit the concentration of investments in a particular business or country?
- Will it participate in consortiums to spread the risk?

Early Warning Signals

Certain elements of management culture and corporate governance are often predictive of, and in some cases, create, underlying vulnerabilities to credit deterioration. Incremental focus on certain management practices and corporate governance may therefore enhance overall understanding. Many failures are the direct or indirect result of some type of fraud and no framework would be able to detect fraud.

A greater scrutiny should ideally be placed on a variety of governance issues including board effectiveness, the audit process, transparency and disclosure, and executive compensation. While, generally speaking, strong corporate governance does not assure credit worthiness, we also have to recognize that in some cases weak corporate governance could undermine credit worthiness, and it seems worthwhile to try to identify such cases.

When appropriate, one should seek to conduct a more in-depth review of accounting policies and practices as a prominent focus of supplemental analysis. An unwillingness to provide adequate transparency may be indicative of a company trying to obscure its true economic performance or financial condition. An issuer may attempt to use an overly aggressive interpretation of accounting standards in order to keep up the pretense of adequate or superior financial health or performance.

We observe some of the factors outlined below give rise to Early Warning Signals in a company to demonstrate the existence of management risk:

1. Degree of aggressiveness in company's business model, growth and acquisition strategy/pattern
2. Aggressiveness of expansion into new/unproven products, business lines, industries and/or markets
3. Major shifts or u-turns in business/operating strategy
4. History of restructurings, asset sales and lay-offs
5. Aggressiveness in Shareholder Value Creation /Equity Price Appreciation Strategy
6. Degree of aggressiveness or excessiveness of CEO and senior executive compensation and benefits
7. Over-reliance on/excessive power of/domination by, CEO or other senior executives
8. High and/or unexpected senior management or board of director turnover/departures
9. Aggressive Corporate Culture and Practices - "Take no prisoners" corporate culture
10. Frequency of Litigation and Legal Disputes against Company
11. History of Government or Regulatory Actions, Judgments or Settlements against Company
12. Aggressiveness or complexity in Corporate /Operating / Tax/Ownership Structure
13. Aggressiveness /complexity in financial / leverage structure
14. Financial Stability/Liquidity sensitive to (i) triggers or (ii) contingents or (iii) access to non-operating sources of cash
15. Degree of reliance on derivatives and off-balance sheet structures for profitability and/or capital management aggressive strategy/ history of revenue or income recognition and/or understating costs or liabilities
16. Aggressiveness, Frequent Changes and/or Complexity in Accounting Practices and Reporting

3.3 To have an Eye on Financial Management & Discipline

Financial management and discipline are important in determining the rating that is assigned to the company. A good company that has excellent products and good management at the helm may still fail if due importance is not paid to the financial health of the company.

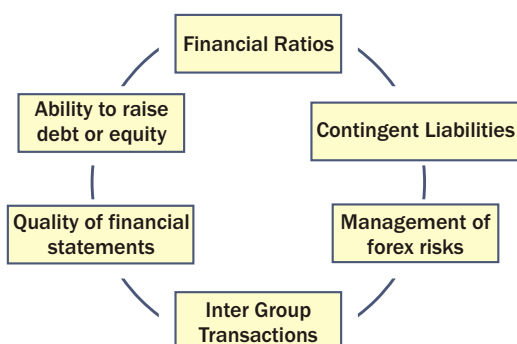
3.3.1 Why is financial performance considered so important by rating agencies?

A company unable to manage its working capital requirement or to repay its lenders will be unable to continue its operations. It is expected that a company that believes that it has excellent business strategies in place also show the same through its financial performance.

A rating agency may also discuss with the management on both its past financial performance and projections over the next two to three years to gauge

- If the current financial position of the company can sustain its operations
- If contingent liabilities of the company could materialise and hence affect the cash flow position of the company
- The strategy of the company in managing funds
- The company's sources of funds in meeting requirements for planned expansions and improvements
- Past experience of the management in meeting projections\

The main parameters considered while assessing the financial risk are shown below:



Typical financial ratios considered by Brickwork Ratings are listed below:

- Tangible Networth
- Debt to Equity Ratio
- Interest Coverage Ratio
- Debt Service Coverage Ratio
- Net Cash Accrual to Total Debt
- Net Profit Margin
- Return on Capital Employed
- Current Ratio

The definition of these ratios and benchmarks used could vary from one rating agency to the other.

Apart from the ratios listed above, the analyst also considers other financial performance measures such as sales and profit growth, cash conversion cycle etc.

3.3.2 Importance of Qualitative Parameters while assessing Financial Performance

Apart from the ratios indicated in the previous section, qualitative parameters are also considered while assessing the financial performance.

These include:

- Management of foreign exchange risks – Both the amounts as well as the timing of payments and receipts in different currencies could lead to foreign exchange translation loss. A company that has hedged forex risks may fare better than a company that has not hedged the same; however the efficacy of the hedge needs to be understood.
- Quality of financial statements - The accounting practices used, changes in the same and frequency of such changes, the availability of audited accounts etc. play an important role in assessment of financial statements.
- Ability to raise funds - The ability of the company to raise equity and debt are considered essential in case of a downturn or cash crunch in the company.
- Financial discipline - The company's track record with respect to paying its debts in full and on time is considered. A company that has earlier missed payments may be rated lower than if it had honoured its payments on time.
- Inter Group Transactions - Inter group transactions where cash flows flow into various sister/group companies are assessed. In cases where it is considered that cash flow fungibility could be a concern, the rating reflects the same.

3.3.3 Financial Discipline - Difference between a Rating Agency and a Bank/Financial Institution

One of the main differences between assessment of a company by a rating agency and a bank lies in their definitions of default. A bank considers an account to have defaulted if it has not received dues from the company for more than 90 days. On the other hand, a rating agency considers the company to have defaulted if the total dues are not paid by the company on the due date. So non-payment of even 1 rupee by the company on the due date would be considered as a default by a rating agency.

Financial discipline hence becomes critical in companies that are being rated by credit rating agencies. Even in cases where a bank loan has not been rated by the rating agency, delayed payments to banks and other financial institutions could lead to a lower rating being assigned.

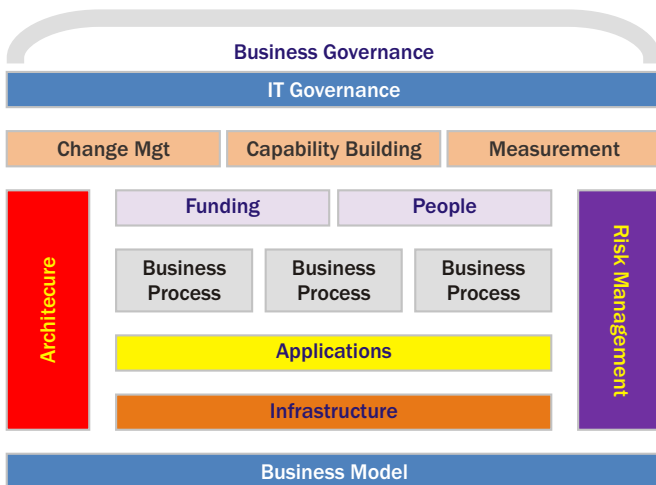
A company that has shown excellent financial results but missed a payment to the bank will be penalised by the rating agency for poor financial discipline. It is hence to the benefit of the company that it put place financial discipline to ensure payments being made on time and in full.

3.4 Use of Cutting - Edge Technology.

Companies must embrace technology to maintain competitive edge

Information Technology is becoming a fundamental enabling infrastructure of the new competitive regime. “Supply chain management requires speed across global space to accomplish what a factory accomplished internally with the assembly line. Information and communication technologies (ICT) are the tools that allow flexible accumulation to function.” ICT is a critical part of what enables the organization and coordination of global production networks and the integration of global chains. It is also an essential element for monitoring what consumers are buying and what they want, and passing that information seamlessly to producing units which often are not even owned by brand name manufacturers. These real time needs of the changing market, indeed even direct interaction with the consumer, as well as electronic exchange and management between different departments and divisions within firms and among firms, their suppliers and distributors, are becoming essential new ingredients of the global economy.

What will you do tomorrow to help your Technology people and manage better?



The amount of data that businesses collect-or should collect-is growing exponentially. The companies believe they can get an edge on competitors by investing in new systems that collect, analyze and share all those numbers, everything from traffic patterns on websites to point-of-sale data in stores.

What's more, employees are demanding access to company systems from any device they choose, not just company-issued computers and BlackBerrys. The companies are eager to comply, seeing a chance to get more out of workers by letting them access internal networks while they're away from the office.

The companies are now being confronted with a handful of technologies that promise to upend the way business has long been done and these technologies in many cases have very positive returns.

The international environment is becoming more competitive, demanding and fast paced. The world has become more integrated through the expansion of trade, investment, and communications. The ICT revolution has also led to an explosion in the internationalization of all types of services that can be done digitally. Thus there is more international competitive pressure. Product life cycles have become shorter. Production, distribution and supply chains have become more integrated globally even as production has become more fragmented across countries.

3.4.1 The global system depends on efficient communications and information system, plus excellent logistics to get goods and services in and out of countries and delivered to the customer in a matter of hours or days, rather than weeks or months. This had led to a speed-up in production and distribution systems. Suppliers have to respond immediately to customer demand.

Most developing countries do not have the pre-requisites to compete successfully in this more demanding global system. It is not just they do not have the latest technologies or skills. **They will have to put in place more agile procedures and ways of doing business.** They also do not have the logistics and infrastructure. Even if they had the money to invest in the physical infrastructure, they do not have the economies of scale for bulk air or sea shipping via the most direct routes to key markets. This means that many developing countries are excluded from these fast paced markets.

3.4.2 India has the advantage in the new competitive system. We have the scale and critical mass of highly trained people and R&D, as well as large internal markets to play successfully in the global system. We are also large and strategic enough to be among the countries developing the rules of the global system. As such we can play an important leadership role for other developing countries.

3.4.3 To remain competitive means more investment in the new ICT infrastructure which has already become so critical in the new real time world. It also means improvement in governance – the ability of the company to respond successfully to the new challenges and to help people falling between the cracks.

3.5 Case Studies on NSIC Ratings Assigned to Micro, Medium And Small Enterprises (MSME)

The “Performance and Credit Scheme for Rating of Small Scale Industries” by NSIC was introduced to enable the Small Scale Industries’ (SSI) sector to

- a) Access funds quickly and cheaply
- b) Improve performance and productivity

Credit rating agencies that are empanelled by NSIC to carry out ratings under this scheme assign ratings as per the rating scale indicated below:

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

Thus, a Company that is rated SE1A on the NSIC rating scale would have the highest performance capability and high financial strength, while a Company that is rated SE5C would have poor performance capability and low financial strength.

Credit rating agencies, while rating the MSMEs on this scale, consider various criteria for assessing financial strength and performance capability; typically financial strength parameters are fixed across industries while performance capability may be measured on a different basis depending on whether the Company is in manufacturing, services or trading.

Case Study 1: Rating a Manufacturing Company

Name of Company: ABC Manufacturing Ltd.
Industry: OEM
Date of Incorporation: 2005
Type of Company: Pvt. Ltd. Company (unlisted)

Rating agencies, during the rating process, will call for certain information from the Company that includes - financial performance (including annual reports), projections such as CMA data available, details on sources of funds, shareholder information and information on Board of Directors, type of technology used, operational parameters including capacity utilization, the type of raw material and sourcing of raw material, vendors, lenders and customers of the Company etc.

It should be noted that rating agencies will rely to a large extent on the data provided by the Company (apart from publicly available information), discussions held with the Management and Company representatives, feedback from vendors, lenders and customers etc. When the information sought is not forthcoming / minimal, the rating assigned may not reflect the true performance of the Company.

Based on this information, rating agencies then assess the Company on two main parameters:

1. Financial Strength
2. Performance Capability

It should be noted that these assessments are not stand alone, that is, Companies’ performance will be judged both over time and with their peers in the cluster that they belong to.

1.1 Assessment of Financial Strength

The financial strength of the Company is assessed based on parameters highlighted in the figure below.

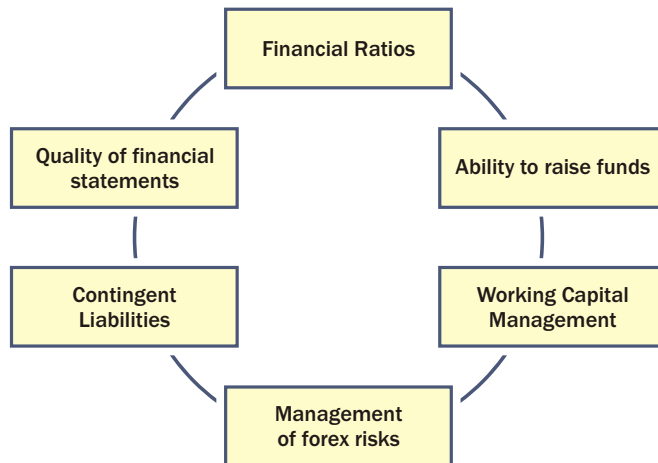


Figure 1: Assessment of Financial Strength

While assessing financial performance, the rating agencies usually call for at least two years of projections. The financial performance of the Company, along with the Projections is represented in the table below:

Table 2: Financial Performance of ABC Manufacturing Ltd.

(All numbers are in ₹. Cr)	Fy2012	Fy2013	Fy2014	FY2015(P)	FY2016(P)
Net Sales	4.00	4.56	4.83	5.12	5.64
Cost of Production	3.12	3.42	3.77	4.05	4.40
Of which					
Cost of Raw Materials	2.65	2.91	3.20	3.44	3.74
Gross Profit	0.88	1.14	1.06	1.08	1.24
Net Profit	0.13	0.34	0.31	0.34	0.50
Growth in Revenue	10%	14.00%	6.00%	6.00%	10.00%
Growth in Cost of Production	8%	9.62%	10.24%	7.36%	8.61%
Growth in Gross Profit	10%	29.55%	-6.72%	1.18%	15.24%
Gross Profit Margin	22.00%	25.00%	22.00%	21.00%	22.00%
Net Profit Margin	3.25%	7.46%	6.35%	6.73%	8.94%
Debt to Equity(Times)	0.67	0.62	0.56	0.51	0.46
Interest Coverage Ratio(Times)	1.26	1.71	1.69	1.81	2.21
Debt Service Coverage Ratio (Times)	0.93	1.15	1.12	1.17	1.38
Inventory Turnover	2	2.4	2.88	2.5	2.8
Cash flow from operations to debt (times)	0.04	0.08	0.08	0.09	0.14
Return on Capital Employed	1.04%	3.43%	3.07%	3.44%	4.99%

Comments on the Financial Performance:

- Overall growth has tapered over the last two years, mainly because of a drop in the growth of the automobile sector in India. This has coupled with increasing raw material prices due to which overall profitability of the company has reduced over the last two years.
- Gearing has improved as the Company has limited its borrowings. Interest Coverage is healthy; however, the debt service coverage shows some stress.
- Return on Capital Employed as well as overall profit margins are below the average industry levels.

Working Capital Management:

The Company's cash conversion cycle is around 120 days, with inventory holding period being around 90 days. The Company has tried to address rising raw material price by hoarding of raw material stock, however, this has led to stress in liquidity of cash flows for the Company.

The days payable are at 30 days while the days receivable are at 90 days. The Company sources raw material from a few vendors and pays them within 30 days, the Customers pay every quarter to the Company.

Management of forex risks:

The Company is not currently exposed to forex risks as its raw materials are sourced from domestic vendors and all its sales are in INR to domestic customers.

Contingent Liabilities:

The Company has a dispute with the tax authorities for an amount of Rs. 1,50,000 and a guarantee provided for a group company to the extent of Rs. 30,00,000.

Contingent liabilities as a % of net worth stand at 0.6%, and hence do not pose a high risk to the Company.

Quality of Financial Statements:

The annual reports have been audited by a local auditing firm. The auditors have not made any adverse comments on the notes to the accounts.

Accounting policies have not been changed significantly.

Ability to raise funds:

The Company's promoters have infused funds through equity infusions to the extent of 4 Cr over the last three years. The Net Worth of the promoters is around 25 Cr, including investments in real estate. The promoters have signified their readiness to infuse funds when necessary.

The Company also has bank facilities with 4 banks including working capital facilities. The Company's ability to raise debt is limited to banks due to its size and financial performance.

Overall performance of the Company with respect to financial strength is hence judged as "Moderate". Main drivers include stress in debt repayments, average ability to raise funds, stress in liquidity and a healthy gearing and interest coverage ratio.

1.2 Assessment of Performance Capability

The performance capability of the firm is judged on two main parameters - Business Performance and Management Performance.

1.2.1 Assessment of Business Performance

1. Market Position

Sl. No	Parameter	Company's Position	Risk Analysis
1.1	Size and Scale of Operations	The Company currently has a plant in Tamil Nadu that manufactures hydraulic break systems, filters and shock absorbers. The size is quite small compared to other players in the geography.	Weak
1.2	Product Range and Diversity	The Company manufactures components for the passenger car and sports vehicle segments. They are considering increasing the product range to cater to the CV segments. Product range is low and flexibility of manufacturing is on the lower side.	Weak
1.3	Customer Base	The customers of the Company include two large car manufacturers with plants in the State. 90% of the Company's sales are to these two companies. Customer concentration is a risk for the Company as there is no particular contract in place.	Weak
1.4	Geography Covered	The Company currently does not export to any other country and has such is not exposed to demand and supply gaps on a global front; its current customers also manufacture and sell within the country.	Moderate

2. Operational Efficiency

2.1	Management of raw material	The Company depends on a number of small traders from which it sources the raw materials required. As such, it is exposed to raw material pricing risk as well as possible supply constraints. The cost of inventory management has increased as a result for the Company.	Weak
2.2	Access to infrastructure	The Company's power and energy needs are met by the state electricity supply; a backup generator is available that allows the Company to meet any power shortfalls up to 10 hours. Water availability as well as road infrastructure are not issues for the Company.	High
2.3	Bargaining power with suppliers	The Company mainly depends on small traders who provide material with cash discounts; however, overall bargaining power is not high as the Company works in a cluster that has many unorganized players in this segment.	Moderate
2.4	Bargaining power with customers	The bargaining power with customers is limited due to the nature of the industry (unorganized and competitive). There is currently no long term contract in place with any customer for the Company.	Weak
2.5	Capacity Utilisation	The capacity utilization has averaged around 65% for the Company. The Company is in talks with other possible customers to improve utilization. The Company is also looking at targeting other sectors apart from the automobile sector to improve utilization.	Moderate
2.6	Adherence to environmental norms and regulations	The Company is in line with the norms and regulations.	Moderate
2.7	Technology used	The technology that is used was updated at the Company in 2010 and meets the requirements of the customers currently. The Company is not considering any technology updation as of date.	Moderate

1.2.2 Assessment of Management Performance

Sl. No	Parameter	Company's Position	Risk Analysis
1.1	Constitution and Ownership of the Company	The Company is constituted as a private limited company and is a family run company. There are three shareholders having equal share in the company - Mr. M and his two sons own the company.	Moderate
1.2	Background and Reputation of Promoters	The promoters have been in the industry for more than fifteen years. The promoters are well known in the industry and are prominent members of industry bodies such as SIAM.	High
1.3	Governance Quality	The Board of directors consists of non-independent directors alone. As such, corporate governance standards are moderate; however, there have been no significant accounting policy changes.	Weak
1.4	Management Quality	The top and middle management consist of professionals; the Managing Director and two other Directors (Finance and Operations) are promoters, however, most of the others are professionals with an average of 20 years in the industry. There is currently no succession plan apart from the family being trained for the business.	Moderate
1.5	Past Record	The Company had delayed one payment to the Bank in 2012, however since then the payments have been regularized. The Company has underperformed on its projects by 20% over the last year.	Weak

Considering the overall performance of the Company, its performance capability is judged as **"Weak"**. Main rating drivers are an experienced management with concentration in industry and customers, moderate capacity utilization as well as high exposure to raw material risks

Case Study 2: Rating a Services Company

The parameters that are used for rating a services company will vary from that of a manufacturing company with respect to performance ability assessment.

Financial strength is assessed based on parameters that are similar to the Manufacturing industry, with two or three differences:

- Current ratio - Current ratio is not considered as important for a services company as it is for a manufacturing company. However, liquidity of operations is still assessed for the Company.
- Capital employed is typically lower in the service industry and hence Return on Capital Employed may seem high when compared to companies in other industries.

Details of the case study are shown below.

Name of the Company: XYZ Solutions
Industry: Manpower Solutions
Date of Incorporation: 2010
Type of Company: Proprietorship

1.3 Overall Rating Assigned

Based on the assessments done above, the Company is rated at **"SE4B"** indicating that the Company's financial strength is moderate and its performance capability is weak.

2.1 Assessment of Financial Strength

The quality of financial statements available with proprietorship concerns as compared with that of a listed company is generally considered weaker.

As a result, even of the financial performance of the Company as provided to the rating agency shows a stronger performance, rating agencies will typically consider the overall strength to be one category lower than what would be given to a limited concern.

Hence, assuming that the financials for Case Study 2 are similar to Case Study 1, the financial strength would be assessed at **"Low"**.

2.2 Assessment of Performance Capability

The ratings analyst considers the parameters that are most relevant to the business that the Company is in.

Usually parameters such as capacity utilisation, cost of raw materials etc. that are relevant to manufacturing companies are replaced by resource utilisation, employee cost and productivity etc. for a services company.

Similar to the manufacturing company, performance capability for a services company is assessed by two main parameters – business performance and management performance.

2.2.1 Assessment of Business Performance

1. Market Position

Sl. No	Parameter	Company's Position	Risk Analysis
1.1	Business Portfolio	The Company currently provides staff for housekeeping, event management and security needs to Corporates. The Company operates with a portfolio that is mainly in the unorganized sector and is open to a lot of competition from other players in the market place.	Weak
1.2	Value Added Services	The services offered by the Company are at the low end of the spectrum and no additional value is added. Companies in this space also provide scheduling and virtual office assistance to Corporates increasing their revenue per customer.	Weak
1.3	Customer Base	The customers of the Company include more than 20 corporates; the top five contribute to around 40% of the revenues of the Company. The customers are across industries.	Moderate
1.4	Geography covered	The Company currently works only from Pune and as such is constrained to certain locations within Pune.	Moderate
1.5	Availability of long term contracts	The Company has contracts with five companies for three years; the others are on an annual basis. As such, demand fluctuates for the Company.	Weak

2. Operational Efficiency

2.1	People Management	The Company has around 50 people on its roll; the others are obtained on a contractual basis as needed from other contractors, thus allowing for optimization of resources. Currently, resource utilization is around 95%. The type of people required for this are usually those with a high school education and with working knowledge of English and Hindi. The availability of personnel is not an issue for the Company.	High
2.2	Skill Development	Currently, the Company does not invest in any skill development for the personnel. It is considering a training programme for its event managers as well as an English speaking course.	Weak
2.3	Working Capital Management	The Company's working capital needs are moderate and are met easily as the clients pay them on a monthly basis.	High
2.4	Pricing	There is no bargaining power with customers as the industry is highly fragmented. The Company also provides low value services that does not allow for higher pricing.	Weak

2.2.2 Assessment of Management Performance

Sl. No	Parameter	Company's Position	Risk Analysis
1.1	Constitution and Ownership of the Company	The Company is constituted as a proprietorship. The main promoter is Ms. S who is a retired banker.	Weak
1.2	Background and Reputation of Promoters	The promoter relies mainly on relationships made earlier as a banker for business development and for word of mouth. The promoter's experience in this industry is relatively new.	Weak
1.3	Governance Quality	The overall quality is low due to the nature of the Company.	Weak
1.4	Past Record	The Company has not delayed on any payments to its lenders or employees. Overall, the past record is a clean record for the Company.	Moderate

Considering the overall performance of the Company, its performance capability is judged as "Weak". Main rating drivers are the low value of the services provided, high competition in the area, the low experience of the management in this segment, high resource utilisation and effective working capital management.

2.3 Overall Rating Assigned

Based on the assessments done above, the Company is rated at "SE4C" indicating that the Company's financial strength is low and its performance capability is weak.

3.6 MSME Credit Ratings Offered by Brickwork Ratings



NSIC - BWR Performance and Credit Ratings for SSIs

To enable small enterprises to get themselves rated, the Government of India has initiated a scheme with subsidized fees for the rating. The National Small Industries Corporation (NSIC) has been appointed as a nodal agency by the Ministry of Micro, Small & Medium Enterprises to implement this scheme.

Eligibility for SSI Ratings under NSIC scheme

Any SSI or micro and small enterprises registered in India can utilize this scheme. The unit which intends to obtain rating has to submit the certificate issued by the registration authority as a proof of eligibility. The completed application form prescribed by NSIC along with requisite documents are required to be submitted by the unit to NSIC as well as BWR for this purpose.

Benefits

- The units (Micro or Small enterprises) rated under Performance & Credit Rating Scheme may be considered by the lending institution for an incentive by way of concessional rate of interest based on the rating.
- Benchmarking - The rating enables MSMEs to benchmark themselves with peer group
- Increased Visibility – The rating reports published in websites and communicated through other media improves the visibility of the brand and publicity for the firm.
- Credibility - The result of independent third party analysis increases the credibility and confidence on the firm among bankers, investors, suppliers, customers etc.
- Comprehensive rating reports - The rating reports indicate the strengths and weaknesses of the firm, which can be helpful for further improvements and growth of the firm.

How to Apply

The application form can be downloaded from BWR's website at <http://www.brickworkratings.com/download/NSIC-BWR-Application.pdf> or can be obtained by sending an email to info@brickworkratings.com. You can send the filled-in rating application form in duplicate along with requisite documents and a cheque/DD in favour of **Brickwork Ratings India Pvt. Ltd.** towards the rating fee, to any of the BWR office. You can also contact our business development executives who will guide you with the process.

List of the documents required to be submitted along with the Application Form

1. SSI Registration Certificate / Entrepreneur Memorandum with Acknowledgment
2. Partnership Deed / Memorandum & Articles of Association.
3. Authority letter issued by the company to sign the application by the authorized person of the company
4. Copy of Income Tax Returns filed for last three years (Non-executive Directors need not submit).
5. Preceding three years audited balance sheet. (Where accounts for the last year have not been audited, provisional accounts duly certified by a Chartered Accountant along with two years audited accounts are to be submitted).
6. Newly incorporated MSE unit has to complete a minimum of 6 months operation and audited Balance Sheet thereof to be submitted
7. In case of a new project/expansion, copy of the project report containing a brief project profile, cost of project, source/means of finance.
8. Details of subsidy, tax concession available to the unit.
9. Quality certificates, Export awards etc received. Membership of any associations.
- 10 Any other information that would enable us to understand your business better.

Time Frame

Brickwork Ratings would complete an assignment within 15 days from the date of receipt of mandate along with prescribed information and fee from the applicant. If there is any delay in getting required information, BWR would communicate to the unit and wait for 30 days. In case of no response, BWR will close the file.

Rating Fee

NSIC - BWR Rating Fee (units with audited results of one complete year of operations)			
	Turnover (₹ Lakhs)		
	< 50	50 to 200	> 200
Rating Fees (₹)	29,359	35,847	48,202
Service Tax 12.36 percent (₹)	4,141	5,053	6,798
Total Fees (₹)	33,500	40,900	55,000
Subsidy from NSIC (₹)	25,000	30,000	40,000
Amount Payable by SSI (₹)	8,500	10,900	15,000

Note: Rating Fee is subject to change from time to time

BWR - SME Rating Scale

SME Rating

BWR SME 1	Offers Highest Degree of credit worthiness in relation to other SMEs.
BWR SME 2	Offers High Degree of credit worthiness in relation to other SMEs.
BWR SME 3	Offers Adequate Degree of credit worthiness in relation to other SMEs.
BWR SME 4	Offers Moderate Degree of credit worthiness in relation to other SMEs.
BWR SME 5	Offers Inadequate Degree of credit worthiness in relation to other SMEs.
BWR SME 6	Offers Low Degree of credit worthiness in relation to other SMEs.
BWR SME 7	Offers Very Low Degree of credit worthiness in relation to other SMEs.
BWR SME 8	In Default or expected to default on maturity.

Note: For SME Rating Fee please contact the following:

Eastern Region: +91 88200 32190 Northern Region: +91 80109 37678
Southern Region: +91 73058 74973 Western Region: +91 80809 28053

Toll Free: 1 860 425 2742

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MSME Related recent articles published by Brickwork Ratings

BWR Performance & Credit Rating Scheme for Small Scale Industries

- D.Ravishankar, Founder Director, Brickwork Ratings

The Micro, Small & Medium-scale Enterprises (MSMEs) play an important role in the development of our country. The MSMEs bring in dynamism, resourcefulness and risk taking abilities to sustain the process of economic growth.

The MSMEs are given increasing policy attention in recent years in view of their contributions, such as: greater utilization of local raw materials, employment generation, rural development, mobilization of savings, linkages with larger industries, balanced regional development and provision for self-employment.

The MSMEs have been defined in the Micro, Small & Medium Enterprises Development (MSMED) Act, 2006, in terms of their investment in Plant and Machinery as follows:

For the Manufacturing Sector	
Enterprises	Investment in plant & machinery
Micro Enterprises	Does not exceed Rs. 25 lakh
Small Enterprises	More than Rs.25 lakh but does not exceed Rs. 5 crore
Medium Enterprises	More than Rs. 5 crore but does not exceed Rs. 10 crore

For the Service Sector	
Enterprises	Investment in equipments
Micro Enterprises	Does not exceed Rs. 10 lakh
Small Enterprises	More than Rs.10 lakh but does not exceed Rs. 2 crore
Medium Enterprises	More than Rs. 2 crore but does not exceed Rs. 5 crore

National Small Industries Corporation (NSIC) is the nodal agency for implementing the Performance and Credit Rating Scheme for Small Industries Sector. The scheme has been formulated in consultation with various stakeholders, i.e. Small Industries Association, Indian Banks' Association and various credit rating agencies. It has the approval of MSME Ministry, Government of India.

The SSI rating methodology shall cover a combination of credit & performance factors including parameters measuring operational, financial, business and management risks. In order to facilitate the ratings process, NSIC empanels the credit rating agencies. Brickwork Ratings (BWR) is one of the empanelled credit rating agency.

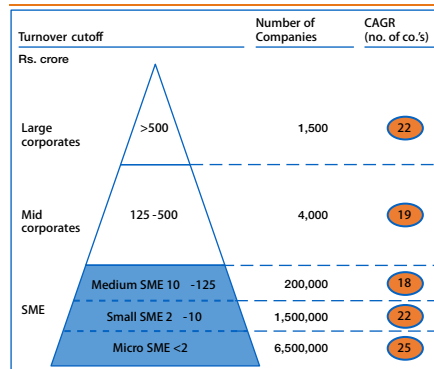
BWR play an important role in bridging the information gap about MSMEs by providing a common yardstick for measuring credit risks

for lenders & investors in the form of credit rating.

The BWR approach for Performance and Credit Rating for SSIs are discussed in the following broad chapters:

- A) MSME – Attention at the highest level
- B) BWR Rating scale & definitions for SSIs
- C) BWR Rating Process
- D) Market demand for credit & business information of small business

A) MSME - Attention at the highest level



India has more than 8 million MSMEs contributing significantly to the country's GDP, exports & employment. Micro, Small and Medium Enterprises (MSMEs) contribute nearly 8 percent of the country's GDP, 45 percent of the manufacturing output and 40 percent of the exports. They provide the largest share of employment after agriculture. They are the nurseries for entrepreneurship and innovation. They are widely dispersed across the country and produce a diverse range of products and services to meet the needs of the local markets, the global market and the national and international value chains.

India's inherent strength and comparative advantage lie in the presence of entrepreneurial acumen of the highest quality, an established scientific and industrial base, cheap skilled English-speaking workforce and a large domestic market. The development strategy is being re-oriented towards enabling our vibrant private sector to reach its full entrepreneurial potential, to contribute towards production, employment and income generation.

The Government has been encouraging and

supporting SSIs through policies for infrastructural support, technology upgradation, preferential access to credit, reservation of products for exclusive manufacture in the SSI sector, preferential purchase policy, etc. etc.

The recent slowdown in the Indian economy in the wake of global slowdown, has prompted the Government to look into various issues concerning the MSME sector, both from the point of view of external impact on it as well as from the standpoint of its potential to trigger positive impulses in the short and medium term. The Parliament Committee has set up two inter-ministerial committees: the first to recommend how the exports from MSMEs can be enhanced, and the second, to recommend on how the production from MSMEs can be enhanced.

During the deliberations with MSMEs, it was repeatedly flagged that the MSMEs, as individual and collective entities, lack the abilities of the larger enterprises to advocate on economic and functional issues, and therefore come adversely on the receiving end of the unexpected actions of the other stakeholders, including the state machinery. The committee has made over 60 recommendations covering issues of regulation, finance, infrastructure, technology and market through the different stages of the life-cycle of MSMEs.

SE 1A: Highest Performance capability; High Financial strength. Prospects of performance are the highest and the entity has high capacity to meet its financial obligations

SE 1B: Highest performance capability; Moderate Financial strength. Prospects of performance are the highest. However, the entity has moderate capacity to meet its financial obligations

SE 1C: Highest performance capability; Low Financial strength. Prospects of performance are the highest. However, the entity has low capacity to meet its financial obligations

SE 2A: High performance capability; High Financial strength. Prospects of performance are high and the entity has high capacity to meet its financial obligations

SE 2B: High performance capability; Moderate Financial strength. Prospects of performance are high. However, the entity has moderate capacity to meet its financial obligations

SE 2C: High Performance capability; Low Financial strength. Prospects of performance are high. However, the entity has low capacity to meet its financial obligations

SE 3A: Moderate Performance capability; High Financial strength. Prospects of performance are moderate. However, the entity has high capacity to meet its financial obligations

SE 3B: Moderate Performance capability; Moderate Financial Strength. Prospects of performance are moderate and the entity has moderate capacity to meet its financial obligations

SE 3C: Moderate Performance capability; Low Financial strength. Prospects of performance are moderate. However, the entity has low capacity to meet its financial obligations

SE 4A: Weak Performance capability; High Financial strength. Prospects of performance are weak. However, the entity has high capacity to meet its financial obligations

SE 4B: Weak Performance capability; Moderate Financial strength. Prospects of performance are weak However, the entity has moderate capacity to meet its financial obligations

SE 4C: Weak Performance capability; Low Financial strength. Prospects of performance are weak and the entity has low capacity to meet its financial obligations

SE 5A: Poor Performance capability; High Financial strength Prospects of performance are poor. However, the entity has high capacity to meet its financial obligations

SE 5B: Poor Performance capability; Moderate Financial strength. Prospects of performance are poor. However, the entity has moderate capacity to meet its financial obligations

SE 5C: Poor Performance capability; Low Financial strength. Prospects of performance are poor and the entity has low capacity to meet its financial obligations

B) MSME Rating Scale & Definitions for SSIs

The Rating Scale, symbols and their definition for indicating the risk score in the rating awarded has been evolved for uniform implementation by the Rating Agencies. The symbols along with their definition while assigning a Rating to Small-Scale Units are placed at Annexure-I. These symbols depict both the performance evaluation as well as the credit worthiness of the unit.

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

The Rating to be awarded by each of the Rating Agencies shall be prefixed by the word NSIC. Thus Rating awarded by Brickwork Rating shall be termed as “NSIC-BWR Performance and Credit Rating”.

Category-I: High Performance capability and high Financial Strength – low risk category

The unit that comes under the green zone as displayed in the following diagram constitute the best companies among SSIs. They are relative with the highest / high performance capabilities and high / moderate financial strength. The various stakeholders, such as banks or counter-parties such as importers, exporters, vendors, etc...should get the highest confidence for dealing with the low risk category. The rating categories include: SE1A, SE2A, SE1B & SE2B. Such rated entities can be put in the fast track category for any lending or counter-party transactions as they belong to low risk category.

Accept Fast Track Low Risk

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

Category-II: High Performance capability, but low financial strength:

This category includes ratings assigned as SE1C & SE2C. The entities under this category possess a high level of performance capabilities. However, their performance levels are very poor. The financial assistance will help them to take them to the low risk category. The care should be taken by Banks to validate their performance capabilities. They also need to ascertain their business continuity aspects before lending to them.

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

High Capabilities but require Financial Assistance

Category-III: Weak / Poor Performance capability, but a high level of financial strength

This category is a classic case where the emphasis should be given for enhancing their business understanding. The assistance in the form of specialised training and technical know-how would help these units to enhance their performance capabilities. Hence, the lenders should be cautious not to go purely based on their current financial position and instead they should take stock of the entities potential road map for enhancing operational performance capabilities. These entities fall under the category of SE4A & SE5A.

High Financial Strength, but require assistance to enhance capabilities

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

Category IV: Moderate Performance capability and Moderate financial strength.

These entities are very average on both performance capabilities and as well financial strength. Hence the stakeholders dealing with this rating category needs to handle it on a case-to-case basis, which means a greater understanding of the company beyond the rating is required. These entities can be converted into a low risk category based on the understanding of their financial needs and training to enhance their skill sets.

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

Moderate financial strength & Moderate Performance capabilities - require

Category V: Weak / Poor Performance capabilities and Moderate / Low Financial strength -High risk category:

These entities fall under the high risk category and their rating falls under SE4B, SE5B, SE4C & SE5C. The lenders need a cautious approach while lending to this category due to the inherent weakness in financial strength and performance capabilities.

		Performance Capability				
		Highest	High	Moderate	Weak	Poor
Financial Strength	High	SE 1A	SE 2A	SE 3A	SE 4A	SE 5A
	Moderate	SE 1B	SE 2B	SE 3B	SE 4B	SE 5B
	Low	SE 1C	SE 2C	SE 3C	SE 4C	SE 5C

Reject/Exit High Risk

C) BWR Rating Process for SSIs

Steps in Rating Process

- Submission of Application form by SSI along with the rating fee
- Submission of Information by SSI unit
- BWR discussion with SSI Management
- BWR Analysis of Information obtained from the SSI Unit
- BWR Assigns Ratings

I) Submitting application form

The SSI unit will have to submit its application for rating in duplicate. It can be submitted to any of the offices/branches of NSIC or directly to the Rating Agency selected by the Small-Scale Unit. On receipt of Application, NSIC will forward the 2nd copy along with the information and documents submitted by the unit to the Rating Agency along with their comments, if any. Alternatively, if the Application is submitted to the Rating Agency, one copy of the application shall be sent by Rating Agency to NSIC for their reference and comments.

BWR application form can be downloaded from BWR's website at <http://www.brickworkratings.com/download/NSIC-BWR-Application.pdf> or can be obtained by sending an email to info@brickworkratings.com. The filled-in application form along with the applicable fee should reach our office or submitted to our business development executive.

Rating fees

The fee to be paid to BWR shall be based on the turnover of the Small-Scale Units which has been categorized into three slabs. The slabs of the Turnover and the Share of Ministry of SSI towards the fee charged by the Rating Agency have been indicated in the table given below:

Rating Fee

NSIC - BWR Rating Fee (units with audited results of one complete year of operations)			
	Turnover (₹ Lakhs)		
	< 50	50 to 200	> 200
Rating Fees (₹)	29,359	35,847	48,202
Service Tax 12.36 percent (₹)	4,141	5,053	6,798
Total Fees (₹)	33,500	40,900	55,000
Subsidy from NSIC (₹)	25,000	30,000	40,000
Amount Payable by SSI (₹)	8,500	10,900	15,000

Note: Rating Fee is subject to change from time to time

The portion of the fee to be subsidized by the Ministry shall be released through NSIC after submission of the Rating Report to NSIC by the Rating Agencies.

ii) Submission of information

- SSI Registration certificate
- Partnership Deed / MOA
- Authority letter by the company to sign the application form by the authorised person of the company.
- Copy of IT returns filed for the last 3 years
- Preceding three years audited financials
- Details of subsidy, tax concession available to the unit
- Quality certificates,
- Any other information that would enable us to understand the business better

iii) BWR discussion with SSI Management

BWR would conduct onsite inspection of the SSI facilities and also discuss with the management. BWR senior officials would also interact over a conference call with the Management of SSI for a better appreciation of the business model.

iv) BWR Analysis of information obtained from SSIs

The main building blocks of the rating criteria used while assessing the SSIs can be divided into four main silos - industry, business, financial and management risks. The knowledge of these criteria can help companies understand the concerns of the credit rating agency and can also serve as a roadmap by which they can improve their creditworthiness.

v) BWR assigns rating

BWR shall share a comprehensive rating report and indicate the strengths and weaknesses of the firm, which can be helpful for further improvements and growth of the firm. BWR, being a third party, the independent analysis increases the credibility and confidence on the firm among bankers, investors, suppliers, customers, etc.

D) Market dynamics indicate a demand for credit and business information on Small businesses

Small businesses are typically much more informational opaque than large corporations and often do not have certified audited financial statements that provide credible financial information on a regular basis and usually do not have publicly traded equity or

debt, yielding no market prices or public ratings that might suggest their quality. There are no market standards in any region with respect to assessing or benchmarking SMEs and often banks are independently assessing SME credit risk and loan portfolios.

Even in the most developed markets, the SME data and information space is highly fragmented. Regulatory environments, such as Basel II, which require banks to assess individual risks based on either an external rating (from a rating agency - External Credit Assessment Institution) or an internal rating (internal risk management processes and systems) are driving need for more credit information on SMEs. Europe is adopting new regulatory requirements faster than any other region.

Growth in global trade and cross-border transactions are driving the demand for small business credit information and decision systems for the initial credit application and for monitoring credit portfolios. World Bank (IFC) efforts to introduce the concept of information sharing and the introduction of credit bureaus in developing countries where financial institutions are doing business primarily with SMEs helping drive market development.

Many emerging markets (especially China, India & Russia) lack legal frameworks to support the development of public information sectors and have negative attitudes towards mandatory and voluntary disclosure of credit information. In these markets the data that is available is often not reliable or fraudulent.

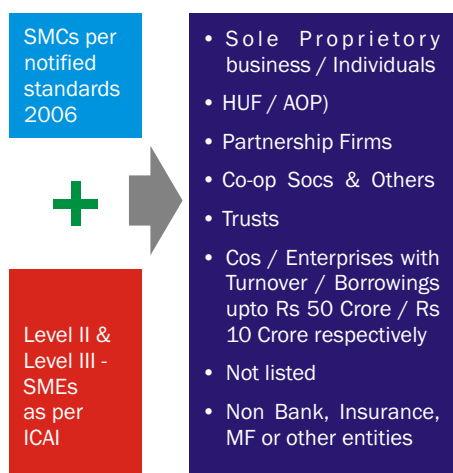
In some countries in Western Europe, businesses are more risk averse and substitute credit insurance for credit information. There is a high-degree of M&A activity in the business information and credit intermediary space indicating increasing importance of these players and alliance and partnerships are being established across the world.

Conclusion

The process of liberalisation and market reforms since 1991 has brought about intense competition for small businesses both in domestic and overseas markets. This has made it imperative for the small businesses to overcome the challenges that they face and maintain, improve and sustain competitiveness through lower cost, improved quality, making available wider choice by initiating various measures including innovation and up-gradation of technology.

Accounting Standards for SMCs and SMEs - R. Krishnan

Small and Medium Enterprises (SMEs)/ Small and Medium Companies (SMCs) are one of the key growth contributors for any economy. It is equally true in India. Recognising its importance there is an exclusive ministry which guides and formulates policies for these enterprises. They contribute nearly 8% of the India's GDP, 45% of the manufacturing output and 40% of the exports and have a largest share of employment after agriculture. Some of the commonly found SMEs in India are given in chart below:



SMEs being a key pillar for facilitating financial inclusion have been supported through concerted efforts in the form of finance, technological, marketing, and a host of measures. One of the key weaknesses flagged off was the lack of adequate disclosures about the state of their finances. Partly, these can be attributed to their inability to hire the professionals and a lack of distinction between personal and business finances. The lenders look forward to see accounts in general to know the statement of affairs to monitor their lending and assess credit worthiness.

Importance of Accounting Standards:

The Accounting Standards have evolved over a period of time considering the extant applicable laws, customs, usages and business environment prevailing in India. Accounting Standards instill sound principles for recognition, measurement, presentation and disclosures of information in the financial statements, improving substantially the quality of financial statements.

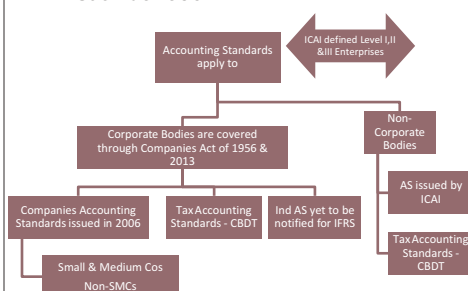
Accounting standards bring the necessary uniformity; is an elegant guide to the true and fair statement of affairs. That said, the topic of accounting standards is too vast to be covered in a single article. Therefore, this article intends to provide a limited view from the standpoint of Company law and the Accounting Standards issued by Institute of Chartered Accountants of India (ICAI) and their positive impact on SMEs.

Accounting standards - Its reference in the Company Law

The reference to accounting standards is important to understand from the point of view of obligatory statutory compliance for corporate bodies. Companies Act, 2013 provides accounting standards as the standards of accounting as may be prescribed for companies to follow. Further, the Draft Rules provides that the standards of accounting notified under the Companies Act, 1956 shall be deemed to be the accounting standards until accounting standards are prescribed by the Central Government.

The interpretation for all companies would be:

- Every profit and loss account and balance sheet of the company shall comply with the accounting standards.
- Accounting Standards means the standards of accounting recommended by the ICAI
- Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose
 - o the deviation from the accounting standards ;
 - o the reasons for such deviation ; and
 - o the financial effect, if any, arising due to such deviation.



As can be seen from the above diagram, accounting standards are applicable across a wide spectrum of enterprises. In Indian context, Accounting Standards cover all:

- Enterprises - corporate, co-operative or other forms,
- Activities of commercial, industrial or business nature,
- Regardless of its being a profit oriented or charitable or religious enterprise.
- Exceptions: Not apply to enterprises which are not of commercial, industrial or business nature and even if a very small proportion of the activities of an enterprise are considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

SMEs defined by various authorities:

MSME Act, 2006 classifies Proprietorship, HUFs, AoPs, co-operative society, partnership firm, company or undertaking as SMEs based on a ceiling of investment in Plant and Machinery/Equipment. The standpoint of accounting standards and the Companies Act the definition of SME is unlike the one provided in MSME Act.

As per Company law:

For the purpose of our discussion in this article we shall restrict ourselves to SMEs defined under the Company law or pronouncements of ICAI. So far, the Institute has issued 29 accounting standards (accounting standard 8 has been withdrawn). SMEs are called SMCs (Small and Medium Companies) as per Companies Accounting Standards Rules 2006. Instead of Level II & Level III entities as envisaged by ICAI, concept of SMCs are Introduced. Companies not falling within the definition of SMC are considered as Non-SMCs. MCA notified Accounting Standards are applicable to SMCs as they are companies covered by Companies Act, 1956. For other than companies, criteria prescribed by ICAI shall continue. The same includes proprietorship firms, Partnership Firms, Trusts, Societies, LLP or any other entities.

As per Company law SMCs are those

which meet all of the following conditions:

- Not listed - equity/debt securities in or outside India.
- Not a Bank/FI/Insurance company.
- Turnover less than Rs 50 Cr
- No borrowings (including public deposits) greater than Rs 10 Cr, and
- Not a holding Company or subsidiary of a non SMC company.

As per ICAI AS:

For the purpose of applicability of ICAI AS, enterprises are classified into three categories, viz., Level I, Level II and Level III. Level II and Level III enterprises are considered as SMEs. Level I enterprises are required to comply fully with all the accounting standards.

Level II and Level III enterprises are required to comply with recognition and measurement principles with some relaxations provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements.

Level I are those:

- Listed equity/debt in or outside India
- Banks including co-operative banks Financial institutions
- Insurance companies
- Turnover greater than Rs. 50 Cr excluding other income
- Borrowings including public deposits greater than Rs 10 Cr
- Holding and subsidiary of above

Level II: fall in any one or more of the following categories:

- Not a Level I entity
- Turnover 1 Cr to 50Cr. (excluding other income)
- Borrowing Rs. 1 Cr – 10 Cr.
- Holding or subsidiary of above

Level III: Enterprises which are not covered under Level I and Level II are considered as Level III enterprises

Difference in Qualifying Levels of borrowings of SMCs & SMEs

- A SME whose borrowings exceed Rs

10 crore at any time during the current period would automatically be deemed to be Level I enterprises

- A SMC that does not have borrowing exceeding Rs 10 crore at any time during the immediately preceding year – will qualify for SMC even if borrowings of current year exceed Rs 10 crores

International Scenario:

In international context, International Accounting Standards Board (IASB) recognises SMEs as those enterprises which:

- do not have public accountability, and
- publish general purpose financial statements for external users.

For instance, external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

An entity has public accountability if:

- its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market; or
- it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

It is noteworthy that, IFRS for SMEs considers some of the above qualitative criteria and additionally, SMEs are exempted from many standards especially considering their cost and size.

There are no separate standards for SMEs in India unlike seen elsewhere in the world. Taking a lead from IFRS which has issued separate standards for SME, many accountants opine that, it would be a welcome move if similar standards are instituted in India. This can do away with the partial or full exemptions or relaxations in applying the existing standards.

Applicability of Accounting Standards - An overview

Accounting Standards	To all Corporate Entities [As per Companies (Accounting Standards) Rules 2006]	To all Non-Corporate entities [As per ICAI Accounting Standards]
AS 1 Disclosure of Accounting Policies	Y	Y
AS 2 Valuation of Inventories	Y	Y
AS 3 Cash Flow Statements	Applicable to Non SMCs only	Applicable to Level I Enterprises only
AS 4 Contingencies and Events Occurring After the Balance Sheet Date	Y	Y
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Y	Y
AS 6 Depreciation Accounting	Y	Y
AS 7 Construction Contracts (Revised 2002)	Y	Y
AS 9 Revenue Recognition	Y	Y
AS 10 Accounting for Fixed Assets	Y	Y
AS 11 The Effects of Changes in Foreign Exchange Rates (Revised 2003)	Y	Y
AS 12 Accounting for Government Grants	Y	Y
AS 13 Accounting for Investments	Y	Y
AS 14 Accounting for Amalgamations	Y	Y
AS 15 Employee Benefits (See Note)	Y	Y
AS 16 Borrowing Costs	Y	Y
AS 17 Segment reporting	Applicable to Non SMCs only	Applicable to Level I Enterprises only
AS 18 Related Party Disclosures	Y	Applicable to Level I Enterprises only
AS 19 Leases (See Note)	Y	Y
AS 20 Earnings Per Share (See Note)	Y	Y
AS 21 Consolidated Financial Statements	Applicable to Non SMCs only	Applicable to Level I Enterprises only
AS 22 Accounting for Taxes on Income	Y	Y
AS 23 Accounting for investments in associates in Consolidated Financial Statements	Applicable to Non SMCs only	Applicable to Level I Enterprises only
AS 24 Discontinuing Operations	Y	Applicable to Level I Enterprises only
AS 25 Interim Financial Reporting (See Note)	Y	Y
AS 26 Intangible Assets	Y	Y
AS 27 Financial Reporting of interests in JVs (to the extent of requirement relating to Consolidated Financial Statements)	Applicable to Non SMCs only	Applicable to Level I Enterprises only
AS 28 Impairment of Assets (See Note)	Y	Y
AS 29 Provisions, Contingent Liabilities and Contingent Assets (See Note)	Y	Y

The above table provides the details where the enterprises/entities/companies have to follow the accounting standards either fully (Y) or partially or exempted based on the criteria.

Exemptions:

- AS 3, AS 17, AS 18 and AS 24 Absolute Exemption provided to SMC and Level II & III enterprises
- AS 25 – is applicable only if a SMC/SME elects to prepare and present an interim financial report

Relaxations:

- AS 15, AS 19, AS 20, AS 28 and AS 29. SMC/SME are exempted or given relaxation only for detailed & complex 'Disclosure' requirements and in some select cases for measurement principles (e.g. AS 15)
- Difference of exemption / relaxation in case of Level II as compared to Level III are not many or material (i.e. AS 18 or AS 24)

Benefits:

The benefits of following the accounting standards whether laid down by the Act or by ICAI far outweigh the onerous nature of its compliance.

One, Accounting Standards lay down sound principles for recognition, measurement, presentation and disclosures of information in the financial statements, which substantially improve the quality of financial statements. Further, being mandatory for companies it facilitates comparison between accounting periods and amongst companies.

Two, it helps in standardising the accounting enabling the lenders too to have a good idea about the company or the enterprise.

Third, and more importantly, it establishes the credit worthiness through facilitating and adopting best practices.

Conclusion:

Accounting Standards form the base of a sound financial reporting system. Integrated with corporate governance, it enables all the stakeholders' to get valuable inputs and information while making important decisions. As stated elsewhere, if the users of the financial information are external, it all the more important to provide a true and fair view of the affairs of an enterprise.

Adequate disclosures regarding accounting policies and the fundamental accounting assumptions form the base. The auditors or the lenders would be scrutinising these closely to ensure that good practices prevail.

India being a signatory to the introduction of IFRS, the road map for SMEs was clearly outlined by the ministry. Corporate entities have to follow notified standards. Non-Corporate entities have to follow the ICAI AS. The auditors are empowered to report non-compliances. As part of best practices, all the entities should follow applicable standards to achieve the goal of good accounting, good reporting and thereby ensure good corporate governance. It is reassuring for all the stakeholders' if an entity follows what is required of it.

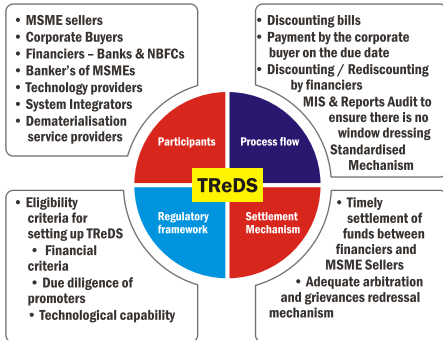
Many accountants feel that a simplified adoption of standards like IFRS for SMEs is the way forward. There may not be a need to reinvent the wheel. These standards already have made available a ready-made disclosure, presentation and illustrations framework. It seems to be quite a comprehensive way to comply and manage the compliance cost. Given the strategic importance of SMEs the regulators and the government, it is hoped by many accountants, would find a way out beginning with a harmonised definition of SMEs and help these entities adopt the best practices.

Source: The ICAI website and resources and literature published by ICAI, MCA website and news reports

Institutional Mechanism for Financing Trade Receivables for MSMEs

- Draft Guidelines for setting up of and Trade Receivables Exchange (TReDS)

- D. Ravishankar, Founder Director, BWR



It is recognized that MSMEs are more dependent on bank financing than are large enterprises which can launch public offerings for debt and equity. The narrow set of financing sources typically available to MSMEs makes them more vulnerable to the changing conditions in the economic environment.

On the other hand, MSMEs play a critical role in the economic development of our country. MSME Ministry estimates a total of around 26.1 million enterprises and 59.7 million persons are engaged in the sector. The MSME sector contributes to a total of 45% of the manufactured output, 8% of the GDP and 40% of India's exports. MSMEs are a source of employment, competition, economic dynamism, and innovation, they stimulate the entrepreneurial spirit and diffusion of skills. Because they enjoy a wider geographical presence than big companies, MSMEs also contribute to a better income distribution.

There are several initiatives taken by the MSME Ministry and Reserve Bank of India (RBI) to develop this segment. One such initiative from RBI is to help the MSME sector to convert their trade receivables into liquid funds through an institutional mechanism. RBI has recently have come out with draft guidelines for setting up of and Trade Receivables Exchange (TReDS).

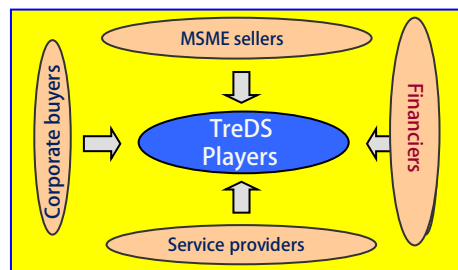
Trade Receivables Discounting System (TReDS)

The scheme for operating the institutional mechanism for facilitating the financing of trade receivables from corporate buyers

through multiple financiers will be known as Trade Receivables Discounting System (TReDS). The objective of TReDS would be to facilitate the discounting of both invoices and bills of exchange.

The TReDS could facilitate both receivables factoring and reverse factoring to generate higher volumes and for better price discovery. The transactions processed under TReDS would be "without Recourse" to the MSMEs.

Participants



The TReDS platform to bring participants together for facilitating uploading, accepting, discounting, trading and settlement of the invoices / bills of MSMEs. The registered bankers of MSMEs and corporate buyers can also access to the system, where necessary, for obtaining information on the portfolio of discounted invoices / bills of respective clients. The TReDS would enable necessary service providers – such as technology providers, system integrators and entities providing dematerialisation services for providing their services.

The process flow

Firstly, there is a need for one-time agreement drawn up amongst participants.

A) Between the financier and TReDS with the terms and conditions of dealings with the entities.

B) Between the Buyer Corporate and the TReDS with i) the buyers' obligation to pay on the due date, ii) no recourse to disputes with respect to quality of goods or otherwise and iii) no set offs to be allowed

C) Between the MSME Seller and TReDS with the declaration from MSME that any finance

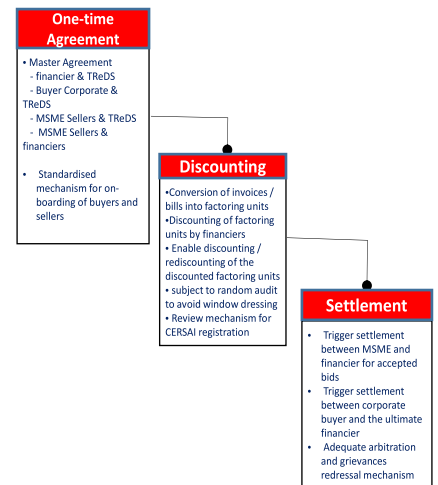
availed would not be part of the existing charge or hypothecation to its bakers for the working capital.

Secondly, there is a need for a suitable mechanism to facilitate financing of invoices / bills of MSMEs drawn on corporate buyers by way of discounting by financiers:

A) Conversion of invoices / bills into "factoring units".

B) TReDS would facilitate discounting of 'factoring units' resulting in flow of funds to MSMEs and at the same time ensuring that the final payment to financier by the corporate buyer on the due date.

C) TReDS would facilitate for further discounting / rediscounting of the discounted factoring units by financiers and thus resulting in assignment in favour of other financiers.



Finally, there is a need for settlement mechanism between the financiers and the MSME sellers and the subsequent settlement of funds between corporate buyers and the respective financiers on the due date.

A) Trigger settlement between MSME and the financier for accepted bids. TReDS will have a separate recourse mechanism to handle settlement failures in respective payment systems.

B) Trigger settlement between corporate buyer and ultimate financier on the due date.

C) Put in place an adequate arbitration and grievances redressal mechanism.

Regulatory framework for setting up TReDS

1. TReDS, participants and various activities would be governed by Payment and Settlement Systems Act, 2007 put in place by RBI.

2. In order to set up TReDS, the following criterial requirements are to be complied:

a) Financial criteria

i) TReDS should have a voting equity share capital of Rs. 100 crs and additional capital may be specified based on the business plan. The networth should be Rs.100 crs.

ii) Promoter's contribution should be atleast 40% and needs to be locked in for a period of 5 years. The contribution in excess of 40% should be brought down to 40% in 3 years. Promoters' contribution needs to be brought down to 30% within a period of 10 years and 26% within 12 years.

iii) Shareholding by foreign entities would be governed by FDI policies.

iv) Entities other than promoters cannot hold more than 10%.

b) Due diligence of promoters

The entities and their promoters/promoter groups as defined in the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009 should be 'fit and proper' in order to be eligible to operate as TReDS. RBI would assess the 'fit and proper' status of the applicants on the basis of their past record of sound credentials and integrity; financial soundness and track record of at least 5 years in running their businesses.

c) Technology capability

i) Need an electronic platform for all the participants

ii) Dissemination of information related to bills / invoices, discounting to be carried out on a real-time basis

iii) Business continuity plan

iv) Surveillance capability for monitoring positions, price and volumes in real time.

Conclusion

The MSMEs through their proven contribution to the national income and distribution of wealth has an important role to play. Hence the necessary policy support from the Government of India and Reserve Bank of India for MSMEs in terms of their access to credit, technology and skill upgradation will go a long way in the continued growth of this sector. The industry associations and other agencies through their role in financial literacy and other initiatives can remove the perceived asymmetry of information & lack of transparency of MSMEs. There is a need for good institutions to come forward and set up TReDS and the regulations are timely for this important initiative.

Crowdfunding – not for the herd but for the discerning

- R. Krishnan

Introduction:

SEBI recently released a paper on Crowdfunding. Globally, it has been receiving fair deal of attention. Crowdfunding is an innovative way to provide funding to entrepreneurs through provision of seed capital. Crowdfunding is solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause. Broadly stated, it is capital raised from:

- Several persons through small financial contributions
- Widely dispersed in early stage projects
- Through internet based platforms, specialist websites and social media

International Scenario in brief:

The SEC, USA issued crowdfunding rules under the Jumpstart Our Business Startups - or JOBS - Act to facilitate crowdfunding and community development finance. Although reliable data on the size of crowdfunding industry is not available, it is believed to be a multibillion-dollar industry and expected to grow rapidly.

Peer-to-Peer Lending and Equity Crowdfunding have seen good growth with Financial Reward (FR) crowd-funding has grown in the last 5 years, with sources indicating that the peer-to-peer lending market growing faster. Collectively, the US, UK and China make up 96% of the overall FR crowdfunding market, with USA accounting for 51%, China for 28% and UK for 17%. IOSCO published a Staff Working Paper titled Crowd-Funding: An Infant Industry Growing Fast, providing a good snapshot of the crowd-funding industry with regulatory views. The flagged investor protection issues and likely systemic risk crowdfunding poses to the global financial services industry. US Jumpstart Our Business Startups Act, 2012 or (JOBS Act) has recommended a basic regulatory framework to regulate Crowdfunding Platforms. Crowdfunding is relatively new to the UK and the market is small, especially compared to the US. However, there is growing interest in it as a route for raising funds and investment.

Major players in equity crowd-funding, globally

Company	Date of Inception	Equity Financed (\$ millions)	Country of Domicile
AngelCrunch	2011	40	China
Crowdcube	2010	23.35	UK
Seedrs	2013	1.36	UK
Bankofthefuture.com Limited	2011	1.33	UK

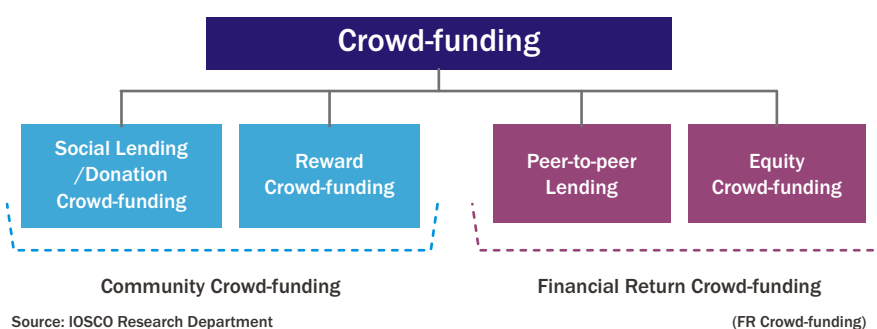
Source: IOSCO Research Department Notes: 1) Data sourced and compiled from individual platforms and does not represent and exhaustive list of platforms. As such this list is a lower bound estimate of the industry; 2)* USD figure is an equivalent based on a GBP conversion at 1.60; RMB figure based on conversion of 6.09; 3)Data is correct at the time of writing; 4) all are equity crowd-funding models.

The report has elucidated the main challenge facing regulators and governments in encouraging crowdfunding and managing the risks posed by its growth and investor protection.

Types of Crowd-Funding

IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast, 2014 ('IOSCO Paper'), states crowdfunding can be divided into four categories: see below

Main	Types	Categories	Remarks
Crowdfunding	Community Crowdfunding	Social Lending /Donation Crowdfunding	Donation crowdfunding denotes solicitation of funds for social, artistic, philanthropic or other purpose, and not in exchange for anything of tangible value.
		Reward Crowdfunding	Reward crowdfunding refers to solicitation of funds, wherein investors receive some existing or future tangible reward (such as an existing or future consumer product or a membership rewards scheme) as consideration.
	Financial Return Crowdfunding	Peer-to-Peer Lending	In Peer-to-Peer lending, an online platform matches lenders/investors with borrowers/issuers in order to provide unsecured loans and the interest rate is set by the platform. Some Peer-to-Peer platforms arrange loans between individuals, while other platforms pool funds which are then lent to small and medium-sized businesses
		Equity Crowdfunding	In Equity Based Crowdfunding, in consideration of funds solicited from investors, Equity Shares of the Company are issued



Regulatory view or their interest:

Innovative products in financial services are an opportunity and at the same time offer risks. An early study of these can lead to a better understanding of the fundamentals and dynamics of this kind of fund raising. Crowdfunding has a similar potential. Since funding is sought online on the foundation of forecasts and sometimes on plans rather than an operating model in operation there is a severe downside risk causing loss to the investors.

Indian crowdfunding scenario through SEBI Consulting paper

SEBI recently released a paper on crowdfunding. The paper has limited itself to its domain of security-based crowdfunding and avoided donation and rewards based funding as also peer to peer lending which comes under RBI. Highlights of some of the key proposals:

- Allowing only accredited investors in crowdfunding;
- Limiting fundraising through crowdfunding to Rs 10 crore in a year;
- Maximum of 200 individual investors including institutional investors;

Besides these, the consulting paper touches upon:

- Extant legal structure governing the fund raising for start-ups and SMEs in India
- Legal and regulatory challenges in implementing the framework for Crowdfunding
- Seeks to balance the above with investor protection.

Since Security Based Crowdfunding is within the domain of SEBI, the potential ways of raising funds are through:

- Equity based Crowdfunding (EbC)
- Debt based Crowdfunding (DbC)
- Fund based Crowdfunding (FbC)

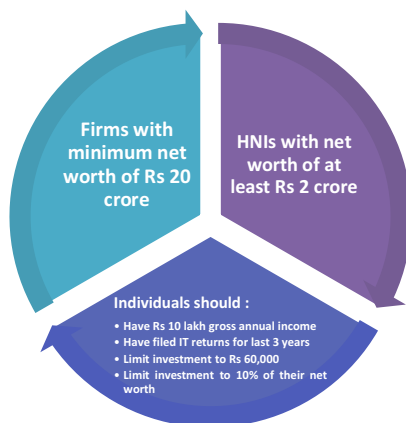
EbC and DbC shall allow private placement offers through internet-based crowdfunding platforms to any number of QIBs and a maximum of 200 HNIs and ERIs combined.

The intended Accredited Investors for investment through the crowdfunding platforms are:

- QIBs as defined in SEBI (ICDR) regulations,

- Indian Companies with a minimum net worth between Rs. 10-20 Crore,
- HNIs with a minimum net worth of Rs. 2 Crores or more
- and Eligible Retail Investors (ERI). The ERIs must be an Indian citizen/NRI.

Crowdfunding investors' requirement:



There are onerous provisions for ERIs if they want to invest. ERIs are those:

- 1 Receiving from an Investment Adviser, or
- 2 Availing services of a Portfolio manager, or
- 3 Passed an Appropriateness Test (may be conducted by an institution accredited by NISM or the crowdfunding platforms), and
 - i With a minimum annual gross income of Rs. 10 Lacs,
 - ii Filing Income Tax return for at least last 3 financial years,
 - iii Providing a certificate to limit the investment amount to Rs. 60,000 in an issue through crowdfunding platform,
 - iv Provide a certificate that they will limit their investment to 10% of their net worth through crowdfunding.

The paper has clearly outlined that any online offering or issue or sale through the internet can be made only through a SEBI recognized crowdfunding platform. Some of the entities who can set up a crowdfunding platform are - Class I Entities like stock exchanges, depositories, Class II Entities like Technology Business Incubators (TBIs) with prescribed parameters and Class III Entities like Alternative Investment Funds (AIFs), Associations and Networks of PE or Angel Investors with appropriate qualificatory requirements.

The paper stipulates that crowd-funding for financial returns will be through a demat account.

Exit route and secondary sale:

Every investor looks for an exit route. There is a catch in this. Crowdfunding by its very nature facilitates raising funds through online and not generally intended for secondary sale. Internationally, many countries don't permit secondary market. Same would be the case for India due to legal reasons. Therefore, exit may be possible when there is sale of the company, a management buyout or a floatation of IPO or listing of company in SME segment.

Benefits:

Crowdfunding provides a fillip to finance start-ups and in particular SME sector thus increasing credit flowing towards them. It also is a new investment route. The 2008 Financial crisis and the resultant Basel III Capital adequacy norms have limited Banks ability to lend money to the ventures or start-ups with high risk element. There is an opportunity for SMEs to raise funds at lower cost through crowdfunding.

A few main benefits of crowdfunding are given below:

- Fills the credit gap left by banks;
- Offers lower costs for capital/high returns, leveraging off a lower cost basis;
- Provides a new product for portfolio diversification.
- Provides direct access to investors and finance that more traditional investors, venture capitalists or lenders are not prepared to offer.
- Enables investors to make small investments across a range of opportunities

Risks:

Like any investment opportunities crowdfunding opportunities could be high risk. There is also a feeling that institutional risk will be substituted by retail risk. Further, fraudsters falsely claiming to be promoters or false websites being started, aiming to defraud the investors or to entice individuals to part with money is a serious possibility.

A few risks are underlined below:

- No guarantee investors will receive a return on investment through crowdfunding.
- risk of default;
- Systemic Risk
- Information Asymmetry
- Substitution of Existing Regulatory Framework
- platform risk;
- risk of fraud;
- risk of illiquidity; and
- risk of investor inexperience.

The above could arise primarily due to low level of disclosure, due diligence, lack of adequate legal framework and some provisions like credit rating may not be applicable through these platforms.

Need for crowdfunding:

There is an ongoing debate on the need of crowdfunding. The banks' ability to lend to start-ups and ventures are limited due to new capital adequacy requirements. IOSCO Paper refers to significant drop in bank loans in USA and Europe. Growth rates to SMEs in the European Union have been negative. The paper notes that there is a funding vacuum, which is filled in by peer-to-peer lending and other Crowdfunding Platforms. It has gained in popularity due to the above reasons. It is also felt while it is an exciting platform to raise funds; the risks are also equally lurking in the corner. However, striking a proper balance between fund raising and protection to investors, it can play a huge developmental role. A proper understanding of the phenomenon is that crowdfunding should be targeted at sophisticated investors who know how to value a start-up business, understand the risks involved and that investors could lose all of their money.

Conclusion:

SEBI's paper explores the possibility of Security based crowdfunding within the existing Indian legal framework. SEBI paper remarks that this is only an initial

consultation process with a caveat that there is no certainty that a specific regulatory regime for crowdfunding will in fact be introduced. The SEBI paper's intended new regulations are a welcome move. There is an emphasis on allowing only accredited

investors with a certain net worth to make use of this platform. Regulations in this field are evolving and are of recent vintage. Regulatory recognition including India, of this growing popularity of crowdfunding activities is a right step towards its development. It increases choice and competition in funding space dominated by limited players. Crowdfunding offers less protection to the investors at the moment to the investors against default or fraud by the issuer. Crowdfunding, in short, may not be for the herd but for the discerning.

Source:

SEBI Consultation Paper on 'Crowdfunding In India'

http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf

Crowd-funding: An Infant Industry Growing Fast

<http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>

Disclaimer: The information is drawn from sources believed to be reliable. The views are those of the author and not of BWR. The reader is requested to read the paper available on IOSCO website and SEBI website for further information. SEBI consultation paper is draft in nature. The final guidelines post discussion may be different from the released consultation paper.

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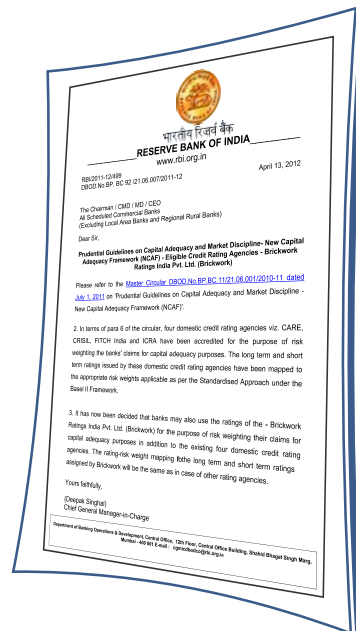
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