Driving responsible growth: Board's imperative in implementing clause (h) under section 43b for MSMEs

Board Leadership Center (India)

MSMEs have long acted as the backbone of the Indian economy, playing a crucial role by contributing approximately 30 per cent to the country's GDP (Gross Domestic Product), 45 per cent to manufacturing output, and employing 11 Cr of India's population, significantly from the non-formal sector[1]. They also play a crucial role in the supply chain, supplying curated products and services that are essential for larger businesses to thrive.

Despite their significant contribution to the economy, it wouldn't be wrong to say that the segment hasn't got the attention that it deserves. It is traditionally beset with challenging financial conditions arising out of inadequate availability of funds and delayed realisation of dues from its buyers.

In corporate boardrooms, where strategies are crafted, risks are weighed, and opportunities are seized, one topic often overlooked is the profound impact of timely payments on business success, especially for companies with smaller scale of operations. For MSMEs, operating on the edge of financial stability, every payment delay can trigger a domino effect, jeopardising their ability to meet operational expenses, sustain cash flows, and invest in growth initiatives.

From a board perspective, ensuring timely payments to MSMEs isn't just a matter of compliance, it's a strategic imperative that directly influences supply chain resilience, vendor relationships, and overall business continuity. Failure to prioritise these payments not only undermines trust with critical partners but also exposes the organisation to reputational risks and potential legal ramifications. Boards must recognise that supporting the MSMEs through timely payments isn't just a gesture of goodwill but a fundamental strategy for fostering a robust and inclusive business ecosystem.

In this article, we delve into the untold power of timely payments in the MSME landscape and discover how embracing this regulatory change can drive sustainable growth, foster innovation, and shape the future of business.

1. Schemes for MSMEs in India, Invest India, May 2024

	Classification of MSMEs
Classification	Manufacturing enterprises and enterprises rendering services
Micro	Investment in Plant and Machinery or Equipment ≤ 1 crore rupees, and Annual turnover ≤ 5 crore rupees
Small	Investment in Plant and Machinery or Equipment ≤ 10 crore rupees, and Annual turnover ≤ 50 crore rupees
Medium	Investment in Plant and Machinery or Equipment ≤ 50 crore rupees, and Annual turnover ≤ 250 crore rupees.

Source: Ministry of micro, small and medium enterprises, Government of India

Decoding the regulation

In a landmark move aimed at bolstering economic resilience and fostering inclusive growth, the government recently introduced a new regulation requiring timely payments to MSMEs. This groundbreaking development, which came into effect on 1 April 2024, marks a significant shift in the business landscape and has the potential to unleash a wave of innovation and opportunity across industries.

The Finance Act 2023 introduced an amendment to the Income Tax Act by adding clause (h) to Section 43B. This amendment disallows companies from deducting expenses from its taxable income, related to goods and services acquired from micro and small enterprises (MSEs) if payments are not settled within 45 days, leading to potentially higher taxes.

In the event of delayed payments to MSMEs, businesses face significant penalties, including compound interest calculated at a rate three times higher than the RBI's Bank rate. This interest accrues from the specified date, compounding the financial burden on non-compliant entities. Furthermore, the accrued interest cannot be deducted as an expense under the Income Tax Act, amplifying its impact on business profitability. These stringent measures serve as a powerful deterrent against late payments, emphasising the importance of prioritising timely payments to MSMEs.

It must be noted that inclusion of the 'payment within 45 days' rule is not a novel concept. The MSME act of 2006 (Chapter V, Section 15) had already stipulated a similar directive, urging buyers of goods and services from MSMEs to settle payments within 45 days. However, the challenge lay in the effective implementation of this provision. With enhanced guidelines and stricter tax penalties in the new Finance Act 2023, there is optimism for improved adherence. By bolstering enforcement mechanisms and introducing penalties, the new MSME payment rule aims to create a fair and transparent ecosystem that supports the growth and sustainability of MSMEs in the long run.

Key points

- Medium enterprises are not covered, the regulation is only applicable to Micro and Small enterprises
- Traders are not covered; this is applicable only on purchases made from good manufacturers and service providers
- Purchases made before 1 April 2023, will not be affected, even if unpaid by 31 March 2024
- Section 43B of the Act provides for certain deductions to be allowed only on actual payment
- Further, the provision of this section allows deduction on accrual basis, if the amount is paid by due date of furnishing of the return of income
- Business enterprises are required to pay MSMEs within 45 days, as per section 15 of the MSMED Act, 2006, depending on the presence of a written agreement. In case there is no written agreement, payment should be made within 15 days
- If there's an ongoing dispute, the timeline starts after dispute resolution
- The rule doesn't apply to buyers opting for presumptive taxation
- MSME or non-MSME, it is applicable to all buyers.

How does it benefit MSMEs?

The implementation of this new rule marks a significant step towards supporting the MSME sector and ensuring timely cash flow and financial stability. The implementation of this new rule marks a significant step towards supporting the MSME sector and ensuring timely cash flow and financial stability.

Timely payments: MSMEs will receive payments within a stipulated timeframe, enabling them to manage their cash flow efficiently and meet their operational expenses

Financial stability: With assured payments, MSMEs can better plan for growth, invest in technology, expand their businesses, and contribute more effectively to the economy

Reduced dependency: Dependence on expensive financing options due to delayed payments could decrease as MSMEs receive payments promptly, potentially reducing their financial burden

Enhanced confidence: MSMEs gain confidence in dealing with larger enterprises, knowing their payments will be made within a reasonable timeframe as per the rule.

However, adapting to section 43B(h) may surely present some initial challenges for their buyer's businesses, including - Internal process adjustment, credit cycle reworking, improved cash flow management, increased administrative burden, potential short-term disruption.

Boards can rethink of compliance as a strategic advantage

As this new regulation comes into force, the responsibility of effective implementation rests with Executive management and the Audit committee overseeing Financial Compliance. Audit committees can consider including this as an agenda in the account's adoption meetings. The payables for SMEs can be presented at such meetings along with an age-wise analysis of such payables, corresponding penal interest amount, and the dis-allowance for income tax purposes. Rigour and effective oversight can go a long way in reducing over-dues towards SMEs and taking a positive step in this direction.

The implementation of new this new regulation also provides a compelling case for businesses to rethink their approach to compliance.

- Embracing compliance involves aligning regulatory requirements with broader organisational goals and values. By integrating compliance efforts into the company's strategic planning process, businesses can drive operational efficiency, mitigate risks, and enhance overall performance
- Further, it demonstrates a commitment to ethical business practices and stakeholder interests, fostering trust and credibility among customers, investors, and other stakeholders
- Compliance also serves as a source of competitive differentiation, distinguishing compliant companies from their peers and positioning them as trustworthy partners in the marketplace
- Streamlining compliance processes and investing in robust compliance infrastructure can enhance operational efficiency and facilitate effective risk management.
- Elevating brand image and market positioning: The regulation presents an opportunity for companies to elevate their brand image and market positioning by demonstrating a commitment to ethical business practices, corporate social responsibility, and stakeholder engagement.

As we navigate the complexities of this long-awaited regulatory shift, it is imperative for audit committees to reassess their roles and responsibilities in ensuring compliance and mitigating risks.

Questions for boards and audit committees to consider

- How has historical non-compliance with MSME payment regulations impacted financial statements, tax liabilities, and supplier relationships?
- What measures are being implemented to address gaps in internal controls and processes related to MSME payments?
- How are we assessing the effectiveness of current payment processes and systems in ensuring compliance with newly enforced regulations?
- What steps are being taken to enhance transparency and communication with MSME suppliers regarding payment timelines and expectations, considering past lack of adherence to regulatory requirements?
- What role does the audit committee play in overseeing compliance with MSME payment regulations, and how are we ensuring alignment with regulatory requirements and best practices moving forward?
- How are we communicating the importance of timely payments to MSMEs to stakeholders across the organisation, and what initiatives are being implemented to foster a culture of compliance and accountability?
- What lessons have been learned from past instances of non-compliance with MSME payment regulations, and how are these being incorporated into our compliance strategy and risk management framework?
- How are we staying abreast of any updates or changes to the regulatory landscape related to MSME payments, and how are these being integrated into our compliance monitoring and reporting processes?
- How can the audit committee proactively contribute to fostering a culture of compliance and ethical business practices, ensuring that past oversights are not repeated in the organisation's journey towards regulatory adherence and responsible governance?

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