

# CONTROVERSY ON THE DEFINITION OF SMEs

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## Abstract

*The author of the paper initiates a broad debate on the diversity of the definitions associated with SMEs highlighting their incompleteness in relation to a set of criteria. The author's conclusion captures an interesting aspect that could form the basis for future approaches.*

**Keywords:** *SME, quality criteria, indicators, definition.*

**Jel classification:** C51, C61, D04

## 1. Introduction

International experience highlights the special position and importance of small and medium enterprises (SMEs) in the context of their national economies. Experts predict that small and medium enterprises will become the main driver of economic progress in the next period, the backbone of the economy. The attributes of small and medium enterprises put this kind of organizations at the forefront of economic development, but their coordinates define a new configuration of the world economy, favoring the expansion of the SME sector. It is not by chance that OECD estimates that "SMEs represent about 90% of companies legally constituted and use 63% of the global workforce."<sup>3</sup>

## 2. Definition, characteristics and influencing factors

SME definition is usually numerical, but it is difficult to name two institutions or two countries that define small and medium enterprises in the same way.

Although the qualitative characteristics of SMEs easily distinguish them from larger companies, quantitative criteria are used primarily to achieve their dimensional classification<sup>4</sup>.

So the definition of SMEs as components of the national economy has been a questionable endeavor and difficult to achieve without the universally accepted definition.

By January 1996 it was believed that small and medium enterprises are those whose total number of employees is less than 500 people, with the following subdivisions:

- micro-enterprises (1-9 employees),
- small enterprises (10-99 employees) and
- Medium enterprises (100-499 employees)<sup>5</sup>.

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<sup>3</sup> Munro D.(2013), A Guide to Financing SMEs, New York: Palgrave Macmillan, p.24.

<sup>4</sup> Berisha G., Pula J.S. (2015), Defining Small and Medium Enterprises: a critical review, Academic Journal of Business, Administration, Law and Social Sciences, Vol 1, No 1, IIPCCL Publishing, Tirana-Albania, p.17-28.

<sup>5</sup> Savlovschi L.I., Robu N.R. (2011), The Role of SMEs in Modern Economy, Economy. Management Series, Volume 14, Issue 1, 2011, p.277-281.

Such a definition based on a single criterion, employment, resulted in the removal of its use in the European Union statistics. Moreover, in 1996 the European Commission sets out a new way of defining small and medium enterprises, revolving around four strictly quantitative criteria<sup>6</sup>:

- a) number of employees;
- b) annual turnover;
- c) total of assets;
- d) the degree of independence.

A number of employees lower than 250 defines a small and medium size enterprise. The European Commission mentioned that an enterprise can be considered medium only if it simultaneously meets two conditions: the number of employees is between 49-250 and the annual turnover is less than 40 million euros or total assets are not exceeding 27 million euros.

Small enterprises are those that have more than 50 employees and an annual turnover of at least 7 million euros or assets of less than 5 million euros.

In addition to the criteria listed above, a fundamental condition was the independence from larger enterprises. It was established that a large company's shareholder participation in a small and medium enterprise to be less than 25% of the equity of SMEs. This criterion was aimed at differentiating SMEs from legal parties of large enterprises.

Despite the good intentions of the European Commission, it has not taken into account that the definitions of annual turnover and total assets are not uniform in all Member States, which created difficulties for classification.

One of the main challenges for the EU has been to achieve a comparative analysis of SMEs in the Member States, impossible to correlate in the absence of a universally accepted definition<sup>7</sup>. Moreover, the ILO<sup>8</sup> identifies over 50 definitions in 75 countries, with considerable ambiguity in the terminology used.

Quantitative criteria referred to the number of employees, production volume and capacity, turnover, capital, market share etc. Although it seems reasonable criteria, each of them has a number of limitations and / or disadvantages. Thereby in terms of turnover, comparative analysis can be made, but only for companies that are part of the same branch. Also, capital assessment involves a series of updates, the production volume is influenced by the nature of production and production capacity could be applicable only to companies that combine inputs in a similar way. At the same time, the number of employees can't be a rigorous enough criterion too, because if two companies have the same number of employees or almost the same number, they may differ<sup>9</sup> in activity profile, technical equipment, computerization etc., other dimensional elements of the organization, especially those of economic origin ( turnover, capital, profit, etc.)..

Regarding the qualitative criteria, they offer a more extensive analysis of SMEs, including influences on branch of activity, technique and technology used, the positioning in the context of business, and the organizational and management methods and techniques.

Of course, the definition of SMEs is not an easy topic. A serious problem identified in the literature is the terminology used to define those businesses, which no doubt, fall into the

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<sup>6</sup> European Commission (1996), European Commission's proposal of April 3rd 1996, concerning the definition of small and medium enterprises (96/280/EC), published in the Official Journal of the European Commission on 30.04.1996.

<sup>7</sup> Ardic O.P., Mylenko N., Saltane V. (2011), Small and medium Enterprises: a cross-country analysis with a new date set, World Bank Policy Research - Working Paper Series.

<sup>8</sup> International Labour Organization

<sup>9</sup> Nicolescu O. (2008), Management of SMEs – concepts, methods, applications, case studies, Economic Publishing House, Bucharest, p.43.

category of large enterprises. Some studies refer to them as small businesses, others use the concept of small and medium enterprises (SMEs), while some refer to them using the term micro and / or medium-sized enterprises. While referring to the same class of businesses, definitions differ in regard to the degree of involvement of the characteristics of these enterprises in their generic name. However, each of these concepts can be used alternatively, each author or institution being allowed to express a preference for any of the names.

The differences in definition of SMEs come from at least three visions:

- ✓ international institutions,
- ✓ the national laws and
- ✓ branch of industry to which they belong.

Identifying a universal standard definition is a challenge for institutions as well as for economists, academics and industrialists. Although it remains a dilemma, juggling terms of enterprise and business has become almost imperceptible and most authors use these names interchangeably.

The abbreviation "SME"<sup>10</sup> is used by the European Union and international organizations like the World Bank, United Nations and World Trade Organization, and refers to those companies which do not fall within the criteria of large companies, reason for which they are labeled as small and medium enterprises<sup>11</sup>.

Despite the lack of universality and alignment when it comes to criteria, the importance of the SME definition is undeniable, being particularly important and useful in the production of statistics and monitoring the status of the sector over time, in benchmarking with other economies and other regions within the same economy, in providing arbitrary thresholds for taxation or regulation, to determine eligibility to access certain forms of public support<sup>12</sup>.

One of the first attempts to provide a definition of SMEs is that of Bolton, in a 1971 report cited by Carter and Jones-Evans in 2006<sup>13</sup>. This report brings into focus two approaches to the definition: a quantitative approach and a qualitative approach. Small and medium enterprises are often characterized by the indications of their size. In this context, economists tend to divide them into classes according to measurable quantitative indicators. As it is well known, the most frequent criterion to distinguish between large and small enterprises is the number of employees<sup>14</sup>.

On May 6th 2003, the European Commission published a recommendation on how to define SMEs. It became operational on January 1st 2005. According to this, „*the Micro, Small and Medium Enterprises (SMEs) category is made up of enterprises which employ fewer than 250 people and whose annual net turnover do not exceeding 50 million euro and / or have total assets whose value does not exceed 43 million euro*”<sup>15</sup>. The European Commission promotes the "number of employees criterion as the main criterion, but nevertheless introduces an additional criterion, of financial nature in order to highlight the real positioning in terms of the company's performance, relative to its competitors"<sup>16</sup>.

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<sup>10</sup> SME – Small and Medium Enterprise

<sup>11</sup> Nwankwo S., Gbadamosi T. (2011), *Entrepreneurship Marketing: Principles and practice of SME marketing*, Abington: Routledge, p.98.

<sup>12</sup> OECD-UNIDO(2014), *Effective policies for small business*, Paris: OECD, [http://ec.europa.eu/enterprise/policies/sme/files/sme\\_definition/sme\\_user\\_guide\\_en.pdf](http://ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_user_guide_en.pdf)

<sup>13</sup> Carter S., Jones-Evans D. (2006), *Enterprise and Small Business: Principles, Practice and Policy* (2nd ed.), Harlow: Prentice Hall, p.21.

<sup>14</sup> Hatten T.S. (2011), *Small Business Management: Entrepreneurship and Beyond* (5th ed.), Mason:South-Western Cengage Learning, p.56-60.

<sup>15</sup> <http://www.aippimm.ro/categorie/imm/legislatie-imm/>

<sup>16</sup> European Commission (2003), *The Commission's recommendation 361/2003/CE from May 6th 2003 concerning the definition of micro, small and medium enterprises*, EC Official Journal, art. 4.

Also, through a guide, the Commission determines as criteria for defining the following: the number of employees, annual turnover and annual balance sheet total<sup>17</sup>. It was stated that achieving the benchmark on the number of employees is mandatory, while the financial performance of the two criteria is up to the company.

The new definition of SMEs which came into force on January 1st 2005 is shown in the table below, which compared to 1996 (values in brackets), financial thresholds have increased due to taking into account the inflation and productivity growth.

**Table 1. SME definition according to the 361/2003/CE Recommendation**

<b>Enterprise category</b>	<b>Number of employees</b>	<b>Turnover</b>	<b>Total annual balance sheet</b>
Medium enterprises	<250	<50 mil. Euro (40 mil. Euro)	<43 mil. Euro (27 mil. Euro)
Small enterprises	<50	<10 mil. Euro (7 mil. Euro)	<10 mil. Euro (5mil. Euro)
Microenterprises	<10	<2 mil. Euro	<1 mil. Euro

*Source: European Commission, 2005*

The World Bank also uses in the definition of SMEs three quantitative criteria: number of employees, total annual net assets denominated in USD and annual sales also denominated in USD. In order to be classified in one of three categories, microenterprise, medium enterprise or small enterprise, a business must meet the mandatory criterion, that of employees, and at least one of the other financial criteria.

**Table 2. SME definition according to World Bank standards**

<b>Enterprise category</b>	<b>Number of employees</b>	<b>Turnover</b>	<b>Total annual balance sheet</b>
Medium enterprises	>50 ≤300	>3.000.000 USD ≤15.000.000 USD	>3.000.000 USD ≤15.000.000 USD
Small enterprises	>10 ≤50	>100.000 USD ≤3.000.000 USD	>100.000 USD ≤3.000.000 USD
Microenterprises	<10	≤100.000 USD	≤100.000 USD

*Source: Independent Evaluation Group<sup>18</sup>*

Comparing the two definitions presented in the tables above, we can see that the quantitative limits are similar to the number of employees, except that the World Bank threshold increases for medium enterprises to a maximum of 300 employees. Inconsistencies occur in the context of other financial criteria. Except the difference in currency, Euro and USD, which is understandable, the financial criteria used are quite different.

While the EU is using as criteria the annual turnover and annual total balance sheet, the World Bank relies on criteria such as total assets and total annual sales. The financial criteria used by the two institutions have no basis for comparability. Moreover, there are substantial differences in the definition.

World Bank criteria take advantage of more minimalist thresholds than the European Union. While the EU micro-enterprises have a turnover of up to 2 million euros, for the World Bank they cannot exceed annual sales of one hundred thousand dollars... The EU sets the maximum threshold of 50 million euro to delineate medium enterprises from large ones,

<sup>17</sup> European Commission (2005), The new SME definition: user guide and model declaration section, Brussels: Office for Official Publications of the European Communities.

<sup>18</sup> Independent Evaluation Group (2008), Financing micro, small, and medium Enterprises: An Independent Evaluation of IFC's experience with Financial intermediaries in frontier Countries, The World Bank, consulted on 01/29/2016 <http://econpapers.repec.org/bookchap/wbkwpubs/6485.htm>

while the World Bank sets a threshold between 3 million and 15 million dollars for two financial criteria.

Although the number of employees is the most widely used criterion in defining SMEs, it presents many differences in the statistical reports of SMEs from different European countries. Most countries allow SMEs classification but with a variation of 0-250 employees<sup>19</sup>.

Despite being one of the most agreed upon definitions of SMEs (provided by the EU), it is far from being appropriated by Governments of States and policymakers. Although recommended by the EU, this definition is mandatory only for institutions and businesses that accede to non-refundable or partially refundable grants from EU<sup>20</sup>. Furthermore, studies have shown that about a third of the world's states included in the SME enterprises that have fewer than 250 employees<sup>21</sup>.

### 3. Conclusion

In this context, we appreciate that each country exercises its freedom to define SMEs based on specific national conditions, which is why the theory still must face several definitions provided by the SME practice. The table below shows some of these definitions in relation to the number of employees of SMEs.

**Table 3. Distribution of firms by number of employees in different countries / regions**

Country / Region	Micro enterprises	Small enterprises	Medium enterprises	SME	Large enterprises
EU	1 - 9	10 - 49	50 – 249	1 - 249	250+
Australia	0 - 9	10 – 49	50 – 199	0 - 199	200+
Canada	0 - 9	10 – 49	50 – 499	0 - 499	500+
Japan	4 - 9	10 – 49	50 – 249	1 - 249	250+
Korea	5 - 9	10 – 49	50 – 199	5 - 199	200+
Mexico	0 - 10	11 – 50	51 – 250	1 - 150	251+
New Zealand	1 - 9	10 – 49	50 – 99	0 - 99	100+
Turkey	1 - 19	20 – 49	50 – 249	1 - 249	250+
USA	1 - 9	10 – 99	100 – 499	1 – 499	500+

Source: OECD<sup>22</sup>

So we are far from having an international consensus on the definition of SMEs and in this respect there isn't a scientific approach based on macroeconomic indicators, everything is just an arbitrary statistic<sup>23</sup>.

In Romania, the laws in force<sup>24</sup>, as supplemented and amended by undertaking any form of organization of economic activity, autonomous patrimony and authorized under the laws in force to acts and facts of commerce, for profit, in competitive conditions, namely:

<sup>19</sup> Ayyagari M., Beck T., Demirgüç-Kunt A. (2003), Small and medium Enterprises Across the globe: a new database, Working Paper 3127, World Bank.

<sup>20</sup> Carter S., Jones-Evans D. (2006), Enterprise and Small Business: Principles, Practice and Policy (2nd ed.), Harlow: Prentice Hall, p.27.

<sup>21</sup> Kushnir K., Mirmulstein M.L., Ramalho R. (2010), Micro, small, and medium Enterprises around the world: how many are there, and what affects the count? MSME Country Indicators, World Bank / IFC.

<sup>22</sup> OECD (2010), SMEs, Entrepreneurship, and Innovation, Paris: OECD

<sup>23</sup> Gibson T., van der Vaart H.J. (2008), Defining SMEs: a less Imperfect Way of Defining Small and medium Enterprises in Developing Countries, Brookings Global Economy and Development <http://seaf.com/wp-content/uploads/2014/10/Defining-SMEs-September-20081.pdf>

<sup>24</sup> Art.2 from the Law 346/2004

companies, cooperatives, individuals doing business independently and family associations authorized by the legal provisions in force”<sup>25</sup>.

By Order No. 27 / 26.01.2006, the Government changed the criteria for characterization of SMEs, having to meet the following conditions amounted:

- annual average number of employees of lower than 250;
- recorded an annual turnover of 50 million euros or an annual balance sheet result of lower equivalent in RON of 43 million euros;
- are subject to the criterion of independence as defined by the law.

Although the number of employees is an objective easily applied, it has important limitations, primarily because *the number of employees depends on the sector of activity, which makes it difficult to generalize comparisons between different sectors*.<sup>26</sup> Moreover, a business that runs on a large market in a particular sector may be considered small, while a small market in the any particular sector, the same business can be considered medium or large<sup>27</sup>. In this context, we believe that *the definition of SMEs should be made dependent on the sector in which that company operates*.

We also believe that a definition of SMEs in relation to the number of employees is no longer feasible given that *more and more enterprises turn to part – time work, casual work, temporary work or similar forms*. Occupation of labor in full-time regime is falling and workers find innovative forms of employment at work, not only in terms of content of such work, but also in terms of the work program.

In terms of defining the perspective of financial indicators, we believe that we are also dealing with a number of disadvantages that cannot be neglected. It refers to the fact that *the use of turnover as a benchmark whose shortcomings lie in the fact that reporting accounting and financial practices do not support comparability internationally. Cash flow could be a more appropriate indicator* for monitoring progress and performance of an enterprise.

Small enterprises are difficult to define strictly theoretical, they are easier to recognize in practice, compared to large firms. In this regard, a suggestive comparison is shown in the table below

**Table 4. Qualitative indicators that distinguish SMEs from large firms**

<b>Categories</b>	<b>SMEs</b>	<b>Large enterprises</b>
<b>Management</b>	- Owner - Entrepreneur - Personal functions	- Manager – Entrepreneur - Division of labor
<b>Personal</b>	- Lack of employees with higher education - General knowledge	- Dominant position university graduates - Specialization
<b>Organization</b>	- Highly customized contacts	- Mostly formal communication
<b>Sales</b>	- Comparative position indefinite and uncertain	- Strong competitive position
<b>Relationship with customers</b>	- Unstable	- Based on long-term contracts
<b>Output</b>	- Labor - intensive production factor	- Capital - intensive production factor, economy of scale
<b>Developing research</b>	- Intuitive approach, tracking market	- Institutionalised

<sup>25</sup> Art.2 from the Law 346/2004

<sup>26</sup> Stokes D., Wilson N. (2010), *Entrepreneurship and Small Business Management* (6th ed.), Andover: Cengage Learning EMEA, p.73-79.

<sup>27</sup> Lee-Ross D., Lashley C. (2009), *Entrepreneurship and Small Business Management in the Hospitality industry*, Burlington: Elsevier.

<b>Finance</b>	- The importance of family funds, auto financing	- Diversified ownership structure, anonymous access to the capital market
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Source: Yon R., Evans D. (2011)

We infer that the definitions of SMEs should be based on qualitative aspects such as the legal form, ownership, enterprise market position, organizational structure, economic and legal autonomy etc. Unfortunately, such a qualitative definition is very difficult to achieve. However, the main advantage of qualitative indicators to the quantitative indicators is universality, all SMEs in a sector or a country having the same range of features.

*Despite the inconsistency of quantitative indicators, SMEs from different countries tend to emphasize similar characteristics in terms of culture, organization and strategy, which gives them a unique character. Whilst these are qualitative in nature, we believe that they can provide the necessary material to create a homogeneous perspective in analyzing SMEs internationally.*

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\*\*\* Ordinance 27/2006 amending and supplementing Law no. 346/2004, as amended, published in M.O. no.88 / 31.01.2006.

\*\*\*<http://www.aippimm.ro/categorie/imm/legislatie-imm/>