Exploring the new landscape for SME FDs

A White Paper by Pegasus Software Ltd

Despite lobbying by industry groups and recent government action to reduce the level of red tape facing UK business, the credit crunch has brought into sharp focus the very real economic pressures faced by small to medium enterprises (SMEs) in particular[1].

Recent employment legislation in particular has placed a disproportionate burden on the SME, according to the University of Nottingham's Institute of Enterprise and Innovation, and unfortunately this trend looks set to gather pace rather than reverse.

In fact, many SMEs are making a conscious decision not to grow because of the legislative regime in which they operate. The knock-on effect of this is a lack of innovation, a slow-down in job creation and unfulfilled potential to boost the UK economy.

This landscape, combined with other pressing issues such as cash flow, taxation and skills gaps paint a bleak picture for the financial director (FD) to cope with. But in reality, is the picture really as bad as the pundits state? Recent research commissioned by Pegasus Software[2] highlights that economic slowdown is the biggest pressure facing SMEs in 2008. So how should FDs address the current squeeze and navigate the red-tape whilst fighting upward pressures on costs?

This paper examines the current landscape for SMEs and explores the specific skills and resources that FDs need in order to drive growth for SMEs and boost their contribution to the economy in 2008.

THE CONTRIBUTION MADE BY SMEs

According to the Department for Business, Enterprise and Regulatory Reform (BERR) there were an estimated 4.5 million business enterprises in the UK at the start of 2006, an increase of 125,000 on the start of 2005. SMEs together accounted for more than half of the employment (58.9%) and turnover (51%) in the UK in 2006.

Employment in SMEs has grown by 1.2 million since 1997. Innovation has also grown in importance, with 48% of SME employers stating in 2006 that they had undertaken product or service innovation in the past 12 months, compared with 32% in 2005.

Given the importance of SMEs to the UK economy, particularly in terms of innovation and job creation, it is vital that the way ahead is clear for growth. However, despite measures taken by the EU and UK Governments in recent years, evidence is scant that SMEs feel more positive about growth in the future.

THE REGULATORY BURDEN

Indeed, research from the British Chambers of Commerce (BCC) shows that regulation remains the number one concern for businesses ahead of education and skills and the UK's tax burden. And according to Pegasus Software's own research, the majority feel that regulation is set to worsen in the next 12 months.

BCC's Burden Barometer calculates the cost to business of complying with everything from health and safety to employment regulation. It says that the cost to business of complying with new regulation since 1998 has risen steadily to a final figure over 10 years of £65.99 billion.

For most businesses this figure does not represent a direct financial cost, but lost man hours and resources, says the BCC. For smaller companies without in-house legal teams or HR departments, complying with regulation diverts time away from running a successful and profitable business.

The BCC has also stated that almost two thirds of entrepreneurs in Britain believe that excessive regulation and a poorly educated workforce make it much harder to start and build a business today than when the Labour government first came to power in 1997.

[1] An SME is an enterprise which employs fewer than 250 people, has an annual turnover of less than €50m and has no more than 25% of its capital or voting rights owned by a larger form or public body (European Commission)

[2] Research was commissioned by Pegasus Software and polled 450 SMEs in May 2008.

Recent legislation designed to make work more family friendly has had the biggest impact, according to market research undertaken by YouGov. Almost two thirds (63%) of senior executives surveyed believe that the increasing burden of legislation such as longer periods for maternity and paternity leave, age discrimination, holiday entitlements and statutory disciplinary procedures now poses a 'serious threat' to their companies. And that's without taking into account legislative changes around adoption leave, rises in the minimum wage and a reduction in working hours.

Since April 2007, for example, new legislation has allowed women to take up to 12 months maternity leave regardless of how long they are employed in their position. The research found that one in five (19 per cent) of UK directors said they had avoided hiring women of child bearing age because of the legal risk of being caught out by constant changes in rules in maternity pay and time off.

Ruth Lea, Director of the Centre for Policy Studies, has gone on record to say that new employment regulation has made life much more difficult for businesses. "They end up having to cope without a key person for anything up to a year... Red tape is killing the entrepreneurial spirit in this country. Firms cannot start, flourish and prosper if regulations and legislation are growing exponentially as they are now."

The response from the Federation of Small Businesses (FSB) has been to continue lobbying Government not to treat all businesses the same by 'gold plating' legislation, which is unnecessarily onerous and complex for smaller businesses.

The FSB's Tina Sommer said that complying with regulation costs five times as much and takes five times as long for small businesses as it does for large firms. "Our research has found that two thirds of small firms want to grow in the next five years, but half of all small businesses see excessive regulation as a serious barrier to that growth."

THE GOVERNMENT RESPONSE

Recognising the requirement to make the UK economic environment as competitive as possible, the current Government introduced a number of measures in its April 2008 budget to make investment funds available.

John Hutton, Business Secretary, sought to reassure small businesses that he was working with major lenders to ensure investment capital was accessible to them despite the credit crunch. He announced an injection of £60 million through the Small Firms Loan Guarantee scheme, plus Enterprise Capital Funds with around £50 million to invest and a further £100 million of early stage venture capital for entrepreneurs.

As well as announcing a specific £25 million Women Investment Fund to encourage women into setting up new SMEs, John Hutton also pledged to make radical reforms to the regulatory system to reduce red tape by 25% by 2010.

As part of this response, Hutton promised to set out the cost of new regulation in a given period to prevent UK businesses being caught out by new, costly red tape. "It's critical, now more than ever, that the EU considers the impact of new laws on small businesses before they are agreed, identifying at an early stage potential impacts and unintended consequences," he said.

The Government is pressing the EU to make small businesses with less than 20 full-time employees 'regulation free' zones, and also telescope legislative changes into one or two days every year to enable businesses to plan ahead and save money.

However, business leaders' groups still reeling from the increase in capital gains tax to 18% and the introduction of taxation for non-domiciled business managers did not meet the new announcements with 100% positive feedback.

Richard Lambert, the director general of the CBI, said that 'clumsy retrospective' changes to corporate and capital taxes introduced in 2007 had dampened entrepreneurial spirit in the UK. "Partly as a result of global economic conditions, partly as a result of ill-considered political decisions, readings on the UK's entrepreneurial barometer have dipped sharply over the past 12 months," he said.

And a recent survey commissioned by Pegasus Software found that one in three UK SMEs felt the government's response was little more than lip service, while 40% say the measures simply don't go far enough.

THE CURRENT ENVIRONMENT

As politicians continue to debate the issues and as various measures move through the legislative and regulatory framework, SMEs are left to deal with tough economic conditions which are only just starting to filter down from large financial institutions into the local supply chain.

In May 2008, the BCC stated that consumer confidence will be the biggest factor curbing economic growth in the UK and forecast GDP growth to dip from 3% in 2007 to 1% in 2008.

Meanwhile the CBI SME Trends Survey showed that during the quarter leading to April 2008, 51% of respondents said that their average unit costs had gone up, with only 7% saying they had decreased. The balance of 43% was the highest recorded in more than 20 years, driven by higher energy and material costs.

With these increased costs being passed on to customers, there can only be a knock-on effect as prices for consumer products start to increase. The result: a possible return to the good old days of the 1970s, when stagnant economic growth and rising prices prompted economists to coin the term 'stagflation' – a double whammy for SMEs of slower market demand and higher costs.

WHAT CAN FDs DO NEXT?

It's clear that neither the regulatory regime nor the current march towards possible stagflation will change direction in the next 6 to 12 month period. Smart FDs are already considering the way ahead in a new, tougher environment. Outlined below are the top five steps that FDs should take immediately to build a position in which they can weather the storm.

1. Be regulation-savvy

About 130 regulations per annum were generated in the first four years of this Government. The number has increased progressively to about 350 in the year ending June 2007, and company directors are often woefully uninformed about the obligations that they are under. Research conducted last year by YouGov found that 70% of directors and managers admitted to being 'not very well informed' about the new Companies Act, for example, which introduced new obligations for directors in 2006. Almost three quarters of directors felt that increasing legislation is putting them in a legally risky position, many are unaware of how breaches of law by their company could lead to them being criminally prosecuted. Areas of law and regulation that are particularly relevant in this matter are Competition Law, Data Protection Law and Insolvency Law. Information about law and regulation is available from a range of sources, including the FSB, the BCC and BERR.

2. Count the cash

Cash is always king, but even more important in a downturn when the tendency for companies to delay payments becomes more prevalent. The temptation to put off paying the bills is strong, especially when every other player in your supply chain is paying slowly as well. The challenge for SMEs is that even when customers don't pay their bills, fixed costs such as wages, rent and rates still need to be paid. Experts advise SMEs to keep a very careful eye on cashflow, slow payments and potential bad debts so there are as few surprises as possible. Income and outgoings should be reviewed on a weekly basis rather than month by month, so that potential shortfalls can be anticipated and a remedy found in plenty of time. Another tip is to check the terms and conditions of client orders against the SME's own standard quote – sometimes payment terms can vary and cause disruption to company cashflow. This can lead to clients making late payments and the supplier being caught out with no recourse to action. Attention to detail is also important when setting up new account details: there's no excuse for invoices being delayed because the wrong address or addressee has been entered onto the system. Similarly, businesses should ensure that managers and other senior staff keep their eyes and ears open for signs of brewing trouble, such as chance comments from customers that business is slowing down. The sooner you can spot the signs of late payment, the quicker you can get to the front of the queue. And the majority of banks now offer a range of flexible finance options in addition to traditional overdrafts, so exploit the options available in order to avoid 'surprises' further down the line. Finally, it's vital to check the creditworthiness of potential customers. It's tempting to turn a blind eye to this process when wooing a big-name customer, but if that company defaults on a large payment it is a liability and significant business risk rather than an asset.

3. Delight your customers

Market research shows that it's between 3.5 and 4 times more expensive to attract new customers than it is to keep an existing one. And according to research from Safe Information Group, nearly a quarter (23%) of companies in the UK expect new business-to-business customer acquisitions to account for at least half of their annual turnover over the following 12 months, which means they expect 50% of their clients to churn. So the challenge for SMEs in particular is the need to balance efforts to attract new business against the time needed to understand clients' changing requirements and their view of the products and services that they receive. While new business is the lifeblood of any company, customer intimacy is of equal importance. The place to start is with a matrix of key customers, which shows who owns the relationship and what contact has been made with them. Regular meetings and mailshots can then be diarised and customers invited to volunteer comments and questions, either via a website, by e-mail or directly by phone.

4. Keep costs low and productivity high

As well as keeping a careful eye on money coming in and out of the business, SMEs need to understand where they are making unnecessary investments. Can costs be cut on stationery, catering, entertaining or travel? Can recruitment or office moves be deferred? Can the supply chain be made more efficient (in line with lean manufacturing principles)? While some costs, such as wages, interest payments, rent and rates are fixed and cannot be reduced, there is usually a huge amount of slack in the business that can be curtailed.

FDs can no longer afford the luxury of time to make important decisions. And for important decisions to be made quickly, accurate, real-time information is critical. The days of running off lengthy reports, only to have to sift through page after page to source the relevant information, is simply unfeasible in today's SME – particularly when there are tools available to source the relevant piece of information in the appropriate format, at the touch of a button.

Similarly, outdated techniques for financial reporting simply add to the extensive time invested in regulation. While software which enables slicker, streamlined reporting might require additional investment, the mitigation of the regulatory burden and improved productivity offset the cost many times over.

Finally, running a business without a clear, real-time view of operations is tantamount to driving blind. Tools which monitor and assess business performance in order to feed strategy and drive growth are imperative in weathering economic slowdown.

5. Innovate to grow faster

One of the surprising facets of the current economic downturn is the apparent resilience of the manufacturing sector. Expert commentators put this down to the growth of China as the 'world's factory', which has led many manufacturers to outsource the production of low-cost, low-margin goods offshore and encouraged UK players to move into high value manufacturing. So-called 'survivor bias' has resulted from a decade of a strong pound against weaker currencies in export markets plus lower costs in Asia. Over time this has led to weaker companies falling away and stronger, more adaptable and more innovative manufacturers not just surviving but actually thriving in a global market. They do so by moving away from making products that can be produced more cheaply elsewhere into developing high specification, niche products that are difficult to emulate. Manufacturers that have survived have also done so because they have brought innovation to bear on processes as well as products, applying principles such as lean manufacturing to make their facilities as efficient as possible. Although manufacturing only represents 14% of the UK economy, in many ways it is in a better position than the more dominant services sector to weather the downturn. From an FD's point of view, it is worth heeding the lessons learned by the manufacturing sector and helping the business to focus on innovation/higher value work that is difficult to replicate as well as on making the organisation more efficient and streamlined.

CONCLUSION

Despite the actions taken so far by the Government, SMEs face difficult times ahead. However, as certain elements of the manufacturing sector have shown, there are steps that FDs can take to batten down the hatches ready for the storm. Accurate financial information, careful credit checking, cost reduction, customer intimacy, innovation and process improvement are all ways to make sure that businesses are in the best shape possible for the challenges that lie ahead.

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