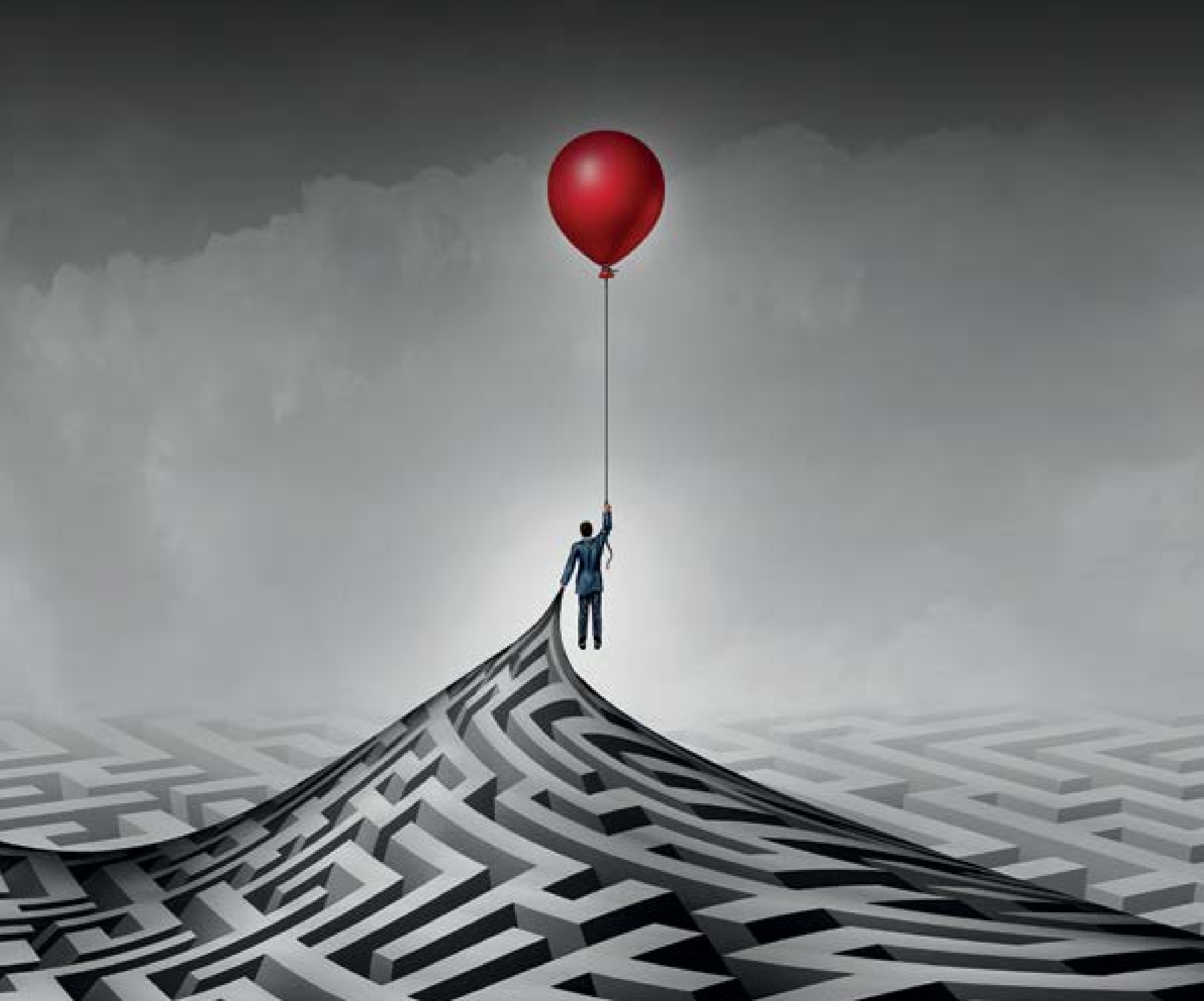
ICAEW AUDIT & ASSURANCE FACULTY

Audit insights: small businesses



BUSINESS WITH CONFIDENCE

icaew.com/auditinsights

About the ICAEW Audit and Assurance Faculty

The ICAEW Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance. *Audit Insights* is one of several initiatives launched by the faculty.

AuditFutures is a thought leadership initiative of ICAEW's Audit and Assurance Faculty, established in 2012 in partnership with the Finance Innovation Lab. As a catalyst for new thinking and fresh perspectives, it aims to inspire collaborative innovation and constructive dialogue about the evolving role of audit and the accountancy profession in modern society.

Through the *re:Assurance* initiative, the faculty is finding out where assurance services over business information, such as key performance indicators, could strengthen markets and enhance confidence and also asking how the International Framework for Assurance Engagements can be applied and developed. The faculty answers demands for practical guidance with publications such as *The Assurance Sourcebook*.

The faculty's Audit Quality Forum (AQF) brings together external auditors, investors, business and regulatory bodies, encouraging stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in external audit.

For more information on the Audit and Assurance Faculty, the current work programmes and how to get involved, please visit icaew.com/audit. To learn more about *Audit Insights* please contact Peter Mandich at peter.mandich@icaew.com, or on +44 (0)20 7920 8900.

978-1-78363-669-3

Foreword

Reports from external auditors aim to build confidence in financial statements and give credibility to companies and comfort to their stakeholders. Companies also benefit from the insight that auditors have into business processes and the wider market environment.

External auditors see many issues during their work in auditing financial statements that have a broader application and are of wider interest than the financial statements alone. This includes issues related to its assets and liabilities, people, processes and the market in which it operates.

Audit insights is an opportunity for external auditors to share some of their knowledge of specific sectors with the public, capturing more value for a wider audience. Shared insights and observations have been brought together in an environment which protects client confidentiality to produce this document.

Audit insights: small businesses is the work of a group of external auditors across a broad range of firms, with many years' combined experience of auditing and reviewing smaller companies. Individual contributors and representatives from the following firms formed the working group: Sandra Higgins, BDO, Duncan & Toplis and James Cowper Kreston.

Small companies form a vital part of the UK economy. According to the 2015 business estimates for the UK from the Department for Business, Innovation and Skills there are nearly 5.4m small businesses in the UK, ranging from internet start-ups, local shops and self-employed contractors to doctors and legal practices and specialist traders and manufacturers. Their importance to the UK economy is shown by the fact that small businesses contribute to almost half of all private sector jobs – more than 12m – and produce an annual turnover of £1.2 trillion, 33% of private sector turnover.

Although large companies tend to grab the business headlines, small companies have their own issues. The small business owner often operates within a very restricted business community and faces daily challenges to run their company. There are several hurdles that small businesses will encounter depending on their size, and it is understandable that owners will not be knowledgeable about how best to deal with all these issues. The most important challenge they face in their early years is to survive.

In this publication we highlight some key areas which we believe are important for the survival of small businesses and put forward ideas for helping start-ups and micro businesses to compete more effectively in a recovering economy. These cover the use of technology; the broad areas of business planning; sourcing finance and cash flow management; managing late payment issues; coping with the demands of regulation and managing contract risk.

By helping owners to navigate the obstacle course of modern business so that they are able to survive, and either successfully grow their businesses or remain the same size if they prefer, they will continue to be at the forefront of driving economic growth in the UK.

Executive summary

Many people choose to set up a small business because it gives them independence, allows them to fulfil a perceived market need and enables them to generate wealth and rewards. Collectively, small businesses, as the engine room of the economy, play an important role in creating jobs, delivering innovation and helping to drive economic growth.

Starting a business is a big achievement, but running one and surviving is a larger challenge. For every 10 new businesses that are created, the life cycle of six existing ones is less than five years (according to research by insurance group RSA). Some fail because they do not have a viable ongoing business, partly the result of inadequate knowledge of their market or overoptimistic and unrealistic expectations of their sales, some because the individuals prefer employment and some because their plan is to sell or exit within the five year period.

If you set up in business, you need to understand what you are letting yourself in for, and that your chances of failure are greater than your chances of success. But this does not mean that you should sit back and let chance decide your fate. Some of the reasons behind small business failures are predictable, and by adapting your behaviour you – as the owner – will increase your chances of success.

We have looked at some barriers and some enablers that can help make the challenge of building a sustainably profitable business easier. In this report we highlight four areas that we believe have the potential to improve the success and survival of start-ups and micro businesses.

Plan in advance to avoid failure

Many small businesses plunge into the competitive arena of setting up a business without a formal business plan. This is compounded by early sales success which reinforces the belief that a plan is not required. But the benefits of good planning will far outweigh any temporary loss of earnings. A well-written business plan will help to convey the unique selling proposition for your business and why people should part with their cash to buy your products or services.

Producing a business plan is only the start of the process. It is essential that as a small business you monitor your own progress regularly so that any changes to your business plans, such as cash flow problems or sales and revenues not on target, can be picked up quickly and any necessary corrective actions taken. Many businesses fail not because they are unprofitable but because they do not manage their cash resources and are unable to pay their debts.

Current business information will also prove useful in supporting a finance application, and enable the owner to renegotiate any borrowed finance before an urgent need arises.

Make sure your IT represents value for money

Digital skills and in most cases online promotion are an essential part of starting and growing a modern business. Businesses that are part of the digital economy are, on average, growing faster than those businesses that are the least digitally able. By using digital technology and having a presence online, small businesses are able to operate more efficiently, connect with a greater number of potential new customers and markets and compete with larger firms.

We recognise that for some small businesses the internet will not be relevant to their work. But for owners who have ambitions to grow their business we have found that some are missing out on the new business opportunities that the internet has to offer because they have no website presence. With the opportunities that are available, more than a million businesses still lack basic digital skills such as running a website, using e-commerce, maintaining a social media presence or using online banking tools according to the latest UK Business Digital Index by Lloyds Bank. This digital blind spot is jeopardising both your survival and your ability to grow. Even if you do not believe that you need to be online many of your customers are.

Most small businesses need to embrace the digital opportunities that the internet offers. The website will be a window into the products and services they offer. But it should be a low-cost investment while owners are growing their business. You should be clear whether you are using the website as an advertising tool or a device for planning sales. This will decide whether your website are set up for receiving payments online. The keys to a successful website is relevant, interesting and timely content which is maintained and refreshed regularly. Keeping navigation simple is also important. It should include the information customers need to buy your products and services and also your contact details for the business. These should be clearly set out and easy to find.

Information technology provides a wide range of tools entrepreneurs can use to guide their new companies through the start-up and growth stages. Modern accounting software packages simplify the process of setting up accounts and posting daily transactions.

Businesses should be wary about 'one size fits all' financial software packages because some sort of tailoring may be required. You need to be clear about your business requirements and what you can afford. You should focus on value-for-money software that will meet your immediate needs, with the ability to upgrade your software as they expand.

Before purchasing a software package you should think about your financial reporting needs, how it will integrate with the rest of your information technology and how to improve its security. You will need to plan for cyber risks, such as computer viruses, scams, data theft and loss of or damage to hardware, and think about what training you or your staff might need.

Executive summary

Good cash flow management is essential

The vast majority of small business owners are not financial experts. In fact, when setting up their business owners are likely to have little or no financial experience to help them manage their accounts and may struggle with basic financial terms such as accruals, working capital or net profit before tax. Cash flow problems can be serious and threaten the ability of a small company to stay in business. Make sure that payment terms are clearly defined in contracts. This will help to avoid any misunderstandings.

Customers, especially if they are large companies, see small suppliers as a source of working capital by paying late. Self-employed and small businesses are reluctant to take action for fear of jeopardising their relationship with their customers who may be their main clients and vital to their future success. They need to understand there is a balance of power relationship which has to be managed in a smarter way. As a small business you need to build into your financial plans that you will experience later payment. It is vital to strengthen relationships with key customers in order to be in a stronger position when it comes to payment disputes.

Adapt to the pressures of running your own business

Running your own business will be stressful. You will need to withstand long periods of uncertainty while managing a range of business risks. These are vulnerabilities that come with the territory and you will need to cope. The key is to accept these pressures as inevitable and to develop the mental agility to respond positively. By learning to live with your vulnerabilities you will be able to fight back and give your business a stronger chance of survival.

Small businesses do not benefit from the bargaining power and protection that consumers have in terms of contract commitment and are less likely to employ the services of lawyers in examining contract terms. They are vulnerable to aggressive sales techniques and can find themselves locked into long-term commitments which cannot be undone without significant investment in time and expense. As a business owner you need to take time to consider contracts carefully before signing them to ensure that the rights and responsibilities of all parties are clearly set out and understood so that they lead to improved cash flow and profitability.

Many owners are not experienced in evaluating the relative benefits and costs of capital expenditure and other long-term investments. They can take a simplistic view, often based on very roughly estimated payback periods and not taking into account some of the variables that might sensibly be considered in financial decision making such as the cost of finance or the time value of money more generally.

Consult professional advisers when it comes to financial decision making. The consequences of failing to get such advice could be significant financial or reputational damage, especially if you are trying to establish your business.

The ability of small business to take risks is disproportionately affected by regulation which increases their compliance costs and acts as a barrier to growth because they are less able to pass these costs on to their customers.

Plan in advance to avoid failure

Business planning

Entrepreneurs are by nature optimists. They get carried away at the launch of their new business and figure their passion and hard work are enough to build a successful business. Unfortunately, many small businesses plunge into the competitive arena without a formal business plan.

It is very tempting to neglect planning altogether, especially if you are the only person in the company. Planning is viewed as a time-consuming process that keeps the business owner away from their primary objective of generating sales. As an owner, you may launch your business with a vague goal that revolves around increasing productivity. But without actionable steps it will not mean much. The benefits of good planning will far outweigh any temporary loss of earnings, and operating without a plan will prove even more time-consuming in the long run.

Owners without a proper business plan run the risk of:

- running out of cash before they begin operating because they haven't properly anticipated their start-up costs;
- missing sales projections because they don't really know who their customers are and what they want;
- losing customers because their product quality or service falls short;
- becoming overwhelmed by too many options because they do not focus on the key objective for their business; and
- going bankrupt because they don't have a rational business model or a plan for how to make money.

Writing a business plan will help you to think more analytically about your competitive environment and the role of your business within it. It will help you to see links between the different parts of the business, for example how decreasing the cost of a particular process will affect the overall profit margin.

Business planning is also essential when sourcing new finance. Providers of finance, such as banks, will want to understand the business applying for the loan and as a potential borrower you will need to provide a robust business plan in support of your application to demonstrate that you fully understand your business and have a clear strategy for growth.

Sourcing the necessary finance is only the start of the process. It is essential for both the borrower and lender that there are regular reviews of the plan submitted with what is actually happening. These reviews not only ensure the business is monitoring its own progress but also enables any variations to the plan to be highlighted in advance so that renegotiations on current or future finance can be started before the need arises.

All these processes require small businesses to have robust and efficient reporting procedures which, if established at the beginning, will pay dividends for the business as it grows. Modern proprietary financial software packages, if set up correctly can easily provide this information.

Plan in advance to avoid failure

Sourcing finance

Businesses are often started on overdrafts, credit cards, with help from friends and family or by using the family property as collateral. But soon after this initial support your business will need to obtain further financing, so that it can stand on its own two feet whether you wish to continue trading as it is or look to grow. The need for cash will vary over time and will be driven mostly by market conditions such as an unexpected downturn in demand or the need to invest in innovation and expansion.

As a business owner you will need to assess different types of finance based on the amount of money required, how quickly the money is needed, the length of time required for the finance and the cheapest option available.

We set out some of the sources available to small businesses together with what we see as their advantages and disadvantages:

Source of finance	Advantages	Disadvantages
Owner's own capital	Doesn't have to be paid. No interest is payable.	There is a limit to the amount an owner can invest.
Retained profits	Doesn't have to be repaid. No interest is payable.	Not available to a new business. Business may not make enough profit to plough back.
Selling off unsold stock	Quick way of raising finance. Reduces the costs of holding them.	Will have to take a reduced price for the stock.
Bank overdraft	Covers the period between money going out and coming in. If used in the short-term, is usually cheaper than a loan.	Interest is payable on the amount overdrawn. Can be expensive if used over a longer period.
Bank loan	Repayments are spread over a period of time which is good for budgeting.	Can be expensive due to interest payments. Bank may require security on the loan. If secured against your property or asset, the business could lose them if they don't keep up repayments.
Mortgage (loan secured on a property)	Payments are spread over a period of time – typically 25 years – which is good for budgeting. Once all repayments are made the business will own the asset.	This is an expensive method compared with buying with cash. If the business does not keep up with repayments, the property could be repossessed.
Leasing	Will have use of up-to-date equipment without paying large sum upfront. Payments spread over a period of time which is good for budgeting.	Can be expensive as it involves making repayments over longer period of time. The asset leased belongs to the finance company.

Source of finance	Advantages	Disadvantages
Hire purchase	Will have use of up-to-date equipment without paying large sum upfront. Payments spread over a period of time which is good for budgeting. Once all repayments made business will own the asset.	Can be expensive as it involves paying an initial deposit and regular payments over agreed period of time.
Invoice factoring and discounting	Improved cash flow by releasing up to 85% of funds against total value of outstanding invoices. Management time is freed to focus on other parts of the business. Benefit from improved profitability as you can pay suppliers earlier, buy in larger quantities and take advantage of any volume discounts available.	Is expensive to use. The factor will want to set credit limits for customers which may affect the way you trade. Exiting the agreement can be difficult. Can affect the relationship with clients as the personal element is affected.
Government grants	May not have to be repaid.	Conditions may apply, eg, location; investment only, training. Not all businesses may be eligible for a grant. Business may be expected to match the grants awarded.
Crowdfunding/Peer-to-peer lending	Fast way to raise finance and no upfront fees. You do not have to give away equity in your business or intellectual property rights.	If you don’t reach your crowd funding target, any finance pledged will be returned to investors. You should check crowdfunding site credentials and conditions carefully because they will have different lending criteria.
Business angels	Business gains fresh capital and access to business expertise. No repayments or interest and no collateral required.	Owner gives up a share of their business. Business angels prefer to have a say in the running of the business which may force the owner to give up some degree of control.
Additional partners	Doesn’t have to be repaid. No interest is charged.	Dilutes control of the business. Profits will be split more ways.

Recommendations for small businesses

It is essential that as a small business you monitor your progress regularly, so that any changes to your business plans, such as cash flow problems or sales and revenues not on target, can be picked up quickly and any necessary corrective actions taken.

Current business information will also prove useful in supporting a finance application and enable you to renegotiate any borrowed finance before an urgent need arises.

Make sure your IT represents value for money

Online presence

The internet has fundamentally changed the way small businesses now operate and grow. It has provided a raft of opportunities to develop and grow small businesses, and created a level playing field by offering low-cost ways of testing and rolling out new business ideas quickly.

Today, if a business does not have an online presence it is likely to miss out on customers, sales and profits, and potentially jeopardise its success. Even if you have no intention of using a website to sell online, a website is still important to let customers know about your business. Buyers commonly research businesses online before actually communicating with them. This can provide useful data on who is visiting their website and is therefore interested in the business and in their products and services. With developments in mobile technology, information about a business can be accessed by customers on the move at any time of the day. The internet also offers small businesses a low-cost alternative to promoting and advertising their product or service. Therefore, it is vital for small businesses to have their own website to help customers find them in the first place.

The keys to a successful website is relevant, interesting and timely content which is maintained and refreshed regularly. Keeping navigation simple is also important. It should include the information your customers need to buy your products and services and also your contact details for the business. These should be clearly set out and easy to find.

The internet can also be a volatile place to do business. In this digital age it is easier than ever for customers to voice their opinions. While a good review can lead to new custom, a bad review can have a much more damning effect with lost business and brand damage that can ultimately lead to the business closing. Small businesses need to embrace the idea that customers are going to post reviews online. Feedback can have a positive effect if it highlights an issue or shortcoming with the product. As an owner you should respond to any negative reviews in a positive and helpful manner. How a negative review is handled has the potential to reassure other potential customers that they can trust the business to take care of any problems that arise.

We recognise that for some small businesses the internet will not be relevant to their work. But if you have ambitions to grow your business we have found that you could be missing out on the new business opportunities that the internet has to offer if your business has no website presence. Some perceive themselves as not having the expertise or marketing background to create an effective website, while others do not see its value. This need not be the case as support is available for those who need it. For example, the government's Do More Online initiative can provide advice to help your small business embrace the digital opportunities that the internet offers.

When planning your business's online presence we advise to:

- research competitors and other businesses that use online tools;
- decide what presence you require online to benefit your business – will you use the website as an advertising tool or a device where you plan to make sales;
- review the budget to work out what you can afford;
- consider IT requirements, including what software and computer equipment you will need to run it; and
- be realistic about the time and budget you will need to manage the online aspects of your business. The website should be a low-cost investment while you are growing the business..

Effective business systems

Effective use of business software internally can lower costs (not just financial but also for example administrative and production) through automation such as recording and measuring sales, costs and profits. It can also be used to automatically generate invoices and formal business correspondence. It is now uncommon for a small business to manually prepare their accounts. Most small businesses at the very least will use a spreadsheet package, while many will also use an accounting software package. There are many such packages on the market which means that deciding on the correct product is not straight forward. ICAEW (Institute of Chartered Accountants for England and Wales) has produced a briefing note to help owners choose the most appropriate accounting software.

Example

A small business which had purchased new accounting software found it was struggling to obtain meaningful profit and loss information. A specialist adviser undertook a review of the system and found that different codes were being used for the same type of expenditure, resulting in it being posted to a number of different accounts. The coding was improved, and the company's staff trained on how to use the new system. The result was that the business was able to monitor its total expenditure more effectively.

The first challenge for any small business owner is to select the correct financial software. Although in theory you could download some software and start using the package, in reality this would not be very sensible. Businesses are different and therefore it is very hard to design a one-size-fits-all software package. Some sort of tailoring will normally be required before the package can be used effectively. You should also focus on value-for-money software that will meet your immediate needs, with the ability to upgrade your software as you expand.

Make sure your IT represents value for money

As well as checking out how good a fit the IT system is for your business, you need to think about the future.

- Does it integrate with other IT systems?
- Can data be exported in a useable format?
- Will the system be able to meet the needs of your business as it grows? If not, what is the upgrade path?
- What is the exit route if the system proves unsatisfactory?
- Will bespoke software end up be being more expensive over the long-term?

As a business owner you should plan for risks, such as computer viruses, scams, data theft and loss of or damage to hardware, and think about the training that you and your staff might need. You will need to protect your data and establish access controls.

The Government's 'Cyber Streetwise' campaign can provide impartial advice and tips about how to make some simple but effective changes to improve online security.

Recommendations for small businesses

Be clear about your business requirements and the total cost of purchasing different types of software. Some software solutions can be too expensive or loaded with features that smaller companies do not need. Seek specialist advice on the product that best suits your specific needs and how it should be operated.

Take advantage of free trial offerings and seek independent advice from current users.

Keep an eye on the latest technological innovations. Because small businesses are unlikely to be encumbered with legacy IT systems you may have more freedom to adopt new solutions that deliver added business benefits.

Manage your cash flow

Managing cash flow is one of the most critical components of success for a small business. Firms that do not exercise good cash management may not be able to make the investments needed to compete, or they may have to pay more to borrow money to continue operating. Despite the fact that cash flow is the lifeblood of small business, and that most small businesses will experience cash flow problems, most owners do not have a proper understanding of this important area. Their primary focus is usually on the generation of sales, and the adequacy of available cash only becomes a problem when it is inadequate. There are some common problems that small businesses will experience.

Higher than expected overhead expenses – these are challenging because they are persistent such as rent, utilities, telephone. They can be managed by monitoring expenses regularly and either cutting back or moving to cheaper options.

Late payment of invoices – this is a common cause of cash flow problems which we examine in more detail in this section. This can be tackled in a number of ways – by providing clients with an incentive, such as a discount, to pay faster by offering them a discount; seeking an increase in their overdraft with their bank or using invoice factoring (borrowing money against sales made) where the cash flow improves with every new customer invoiced. As an owner, you will need to research and balance these options before making your decision as there will be different costs involved.

Stock inventory – monitor stock levels so that items are stored for the shortest possible time, and consider borrowing and holding costs when offered attractive bulk-buying discounts by suppliers. You should also weigh up whether suitable industry-based buying consortia could help to lower stock levels.

Supplier management – identify which suppliers are vital to the survival and growth of the business and then develop a plan to keep the support of each. There will be some inflexible suppliers such as HMRC, who can surcharge for late payment, who will need to receive payments within set timescales.

Bad debt – review the commercial credit of customers and provide payment terms only to clients who have good credit and a solid payment record. Others should prepay until they have built a positive track record with your business.

Late payment

Many small businesses experience considerable difficulties from their customers failing to pay their debts on time. Delaying payment gives the debtor free working capital but puts financial pressure on the supplier. Often the supplier is caught between needing payment and antagonising a large customer.

Many self-employed workers will have a single client at any one time. Failure to be paid on time means they are denied their sole source of income for that particular period, jeopardising their financial security and preventing them from meeting essential household and business bills such as mortgage repayments. Large companies are particularly motivated by public reporting requirements to pay their suppliers late at their financial year end.

Statutory rights exist (under Late Payment of Commercial Debts (Interest) Act 1998), for businesses to claim interest on the late payment of commercial debts. But small businesses are reluctant to take court action against their customers for fear of losing that business. Retrospective discounting continues to be used by large companies to maintain

Manage your cash flow

their margins at the expense of the cash flow of the small business. As the large company can be a significant customer, the small business has little choice but to absorb the change in cost.

Latest research by Bacs has revealed that 80 per cent of UK businesses which experience late payments say they are being kept waiting one month or longer beyond their agreed contract terms before receiving payment. The knock-on effect of this is that business owners have to make tough decisions in order to continue operating. Over a quarter are using their overdrafts to make ends meet and 26% have no choice but to pay their own suppliers late. Some 20% of directors are also being forced to take a pay cut in order to keep cash inside their businesses.

Having to cope with late payment, and the real possibility of non-payment, is forcing small business owners to take action to keep their own businesses solvent at the expense of paying their suppliers on time. This is creating a vicious circle of late payment across the whole supply chain.

Example

We acknowledge the measures in the 2015 Small Business Act to improve late payment. From October 2016 large businesses (defined as those with more than 250 employees) will have a duty to report their payment practices. Although this will increase their administrative burden, it will achieve its objective if it helps to change their behaviour for the better.

To drive best practice the Government has significantly strengthened the voluntary Prompt Payment Code which requires all signatories to commit to paying their suppliers within 60 days, in line with late payment legislation requirements, and work towards adopting 30 days as the norm for payments. Whether the changes will be sufficient to force large businesses to pay promptly remains to be seen. The problem will continue to be significant while a large number remain outside the Code.

Partly in response to this concern the government has announced that it will establish a Small Business Commissioner to resolve disputes around late payment without the need for court action. The Commissioner could play a key role in making sure that small businesses have somewhere to turn when they are being paid late, and could help deliver a better payment culture. Its success will depend on late payment disputes being referred to it. The concern remains that the limited powers currently envisaged – no arbitration and no enforcement of its recommendations – could result in small businesses being unwilling to use the limited nature of the service for fear of jeopardising their relationships with their large customers.

Recommendations for small businesses

Cash flow problems can be serious and threaten the ability to stay in business. If you do not have direct financial experience, ensure payment terms are clearly defined in contracts and seek advice from a trusted financial expert.

Consider formalising and agreeing your terms of business to make sure that you and your customer understand the basis of your working relationship. This will help to avoid any misunderstandings.

Debtors, especially if they are large companies, see small suppliers as a source of working capital by paying late. Self-employed and small businesses are reluctant to take action for fear of jeopardising their relationship with their customers who may be their main clients and vital to their future success. You need to understand there is a balance of power relationship and you need to be smart in how you manage it.

Build into your financial plans that you will experience late payment. As a small business you should strengthen your relationship with your key customers, so that you are in a stronger position when it comes to payment disputes. You can do this by:

- setting the service bar high, making it more risky for the customer to change their supplier;
- tailoring services to the specific needs of your customer's business; and
- building personal relationships with the customer – winning allies can prove valuable in using them to explain your value to the accounts department.

Adapt to the pressures of running your own business

Small business owners are by definition risk-takers as they face a daily challenge to ensure their business survives. The danger is that they can end up taking too many risks, or not spending enough time managing certain risks, for example, contractual or infrastructure risks, and as a result fail to achieve what is possible. As an owner you will need to withstand long periods of uncertainty while managing a range of business risks. These are vulnerabilities that come with the territory. The key is to accept these pressures as inevitable and to develop the mental agility to respond positively. By learning to live with your vulnerabilities you will be able to fight back and give your business a stronger chance of survival.

Through the experience of working with many different companies as auditors, we see issues relating to decision making, to processes and to operational matters which re-occur with a degree of frequency. These reflect the particular pressures and constraints that smaller businesses find themselves under, as a consequence of both the inevitable lack of breadth in management resources and skills and the wide variety of tasks that fall to them.

Contract commitment

Small businesses do not benefit from the protection that consumers have in terms of contract commitment and are less likely to employ the services of lawyers in examining contract terms. This leads to a variety of risks. Small businesses, in particular, are vulnerable to aggressive sales techniques and can find themselves locked into long-term commitments, for example in the provision of utilities, without fully realising what they are signing up to. These commitments cannot be undone without significant investment in time and expense.

The upshot is that as a small business you need to be careful and smarter about the contracts that you enter into. Make sure that you clearly set out the rights and responsibilities of all parties, that you are understood and, importantly, when buying goods and services that you will enhance the cash flow and profitability of the business in the long run.

Example

A small business owner thought about entering into a contract with a printer/copier which had adverse contract terms that were not immediately obvious. This would have meant that the business had to pay considerably more than the intrinsic value of the service. They recognised they did not have financial expertise in evaluating the different cost options and before agreeing to the contract sought advice from a financial specialist. They were provided with cheaper options that saved the company several thousand pounds.

Investment evaluation

As small businesses grow, their owner-managers often try to stretch their skills over several new areas, and can struggle to deal with the expanding complexity of operating a growing firm. Many owners are not experienced in calculating the relative benefits and costs of capital expenditure and other longer term investment. Investment evaluations can be particularly difficult for smaller businesses who do not frequently address these issues. They can take a simplistic view, often based on very roughly-estimated payback periods, without taking into account some of the variables that might sensibly be considered in financial decision making, such as the cost of finance or the time value of money more generally.

Example

A small software business was keen to buy the premises it leased under a relatively short-term arrangement and which had unexpectedly become available for freehold purchase. The directors felt it would give them a solid asset base and security. However, the impact of changing property values on the thin balance sheet that young software companies often have, the likelihood that current financial projections for the company meant that they would require larger premises within three years, and future borrowing costs, meant that after seeking financial advice they decided not to pursue the purchase.

Regulatory risks

Businesses are dealing with increasingly complex compliance requirements. These end up being a greater burden and cost to smaller companies that traditionally operate with minimal internal administrative support and do not have the funds to employ regulatory specialists. The compliance bill for companies with fewer than nine employees continues to rise to the equivalent of £164 per employee – almost seven times the cost for companies with 50 or more workers, according to research by the Forum of Private Business. This level of expense, taken together with the high-penalty levels if businesses get it wrong, pose a real threat to business survival.

In particular the requirements of more regular real time submissions on PAYE, CIS (Construction Industry Scheme), auto-enrolment into a workplace pension scheme, Value Added Tax and health and safety regulations are just some of the matters that detract the owner from their focus of building value in their business. They are time-consuming to complete, with some requiring monthly submissions, which means that small businesses will employ specialists to manage their payroll or advise on auto-enrolment for example. Flat-rate penalties for late reporting can also have a disproportionate impact on small businesses where cash flow is particularly important.

In helping small business the government needs to be careful not to impose additional burdens that increase their costs.

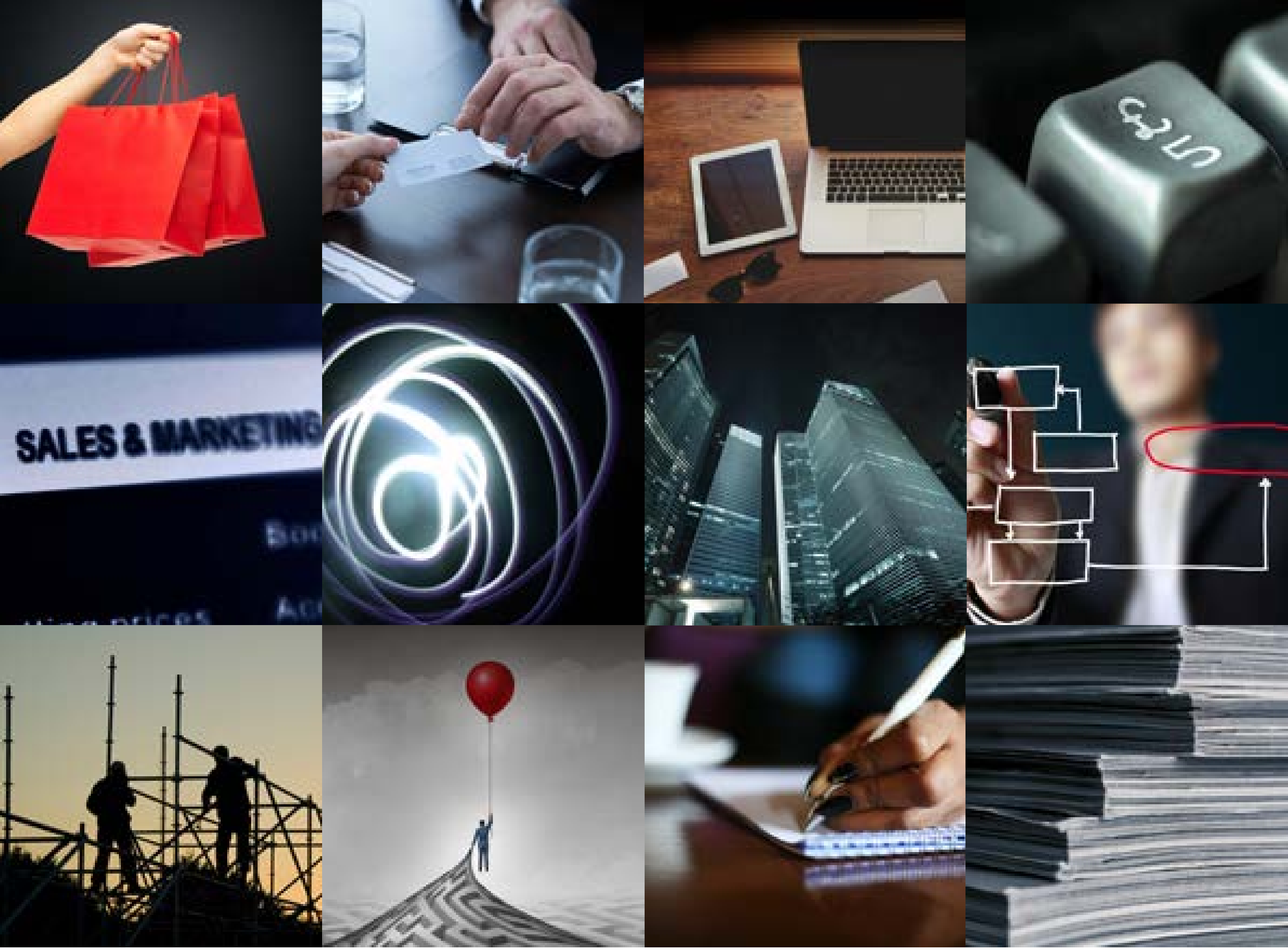
Adapt to the pressures of running your own business

Recommendations for small businesses

Take time to consider contracts carefully before signing them to make sure that they will ultimately lead to improved profitability.

Seek professional advice when it comes to financial decision making. The consequences of failing to get such advice could be significant financial or reputational damage, raising the risk of failure at a critical time when you are trying to establish your business.

Join a club or network of fellow business owners to discuss issues of concern and to benefit from their wider knowledge and experiences. The important thing to remember is that you do not need to deal with your business problems on your own.



Audit insights

A comprehensive series of publications offering unique practical insight and guidance from auditors.

• retail • insurance • corporate reporting • cyber security
• manufacturing • banking • construction • small businesses

icaew.com/auditinsights

Visit our website to access all of the current reports

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 145,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

Because of us, people can do business with confidence.

ICAEW is a founder member of Chartered Accountants Worldwide and the Global Accounting Alliance.
www.charteredaccountantsworldwide.com
www.globalaccountingalliance.com

Chartered Accountants Worldwide
Member

GAA
Global Accounting Alliance

ICAEW
Chartered Accountants' Hall   Moorgate Place   London   EC2R 6EA   UK

T +44 (0)20 7920 8623
E tdaf@icaew.com
icaew.com/auditinsights

facebook.com/icaew
twitter.com/icaew
linkedin.com find ICAEW