THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Ipsos MORI

# SME ACCESS TO FINANCE RESEARCH REPORT

July 2009

Research conducted by: Ipsos MORI

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# INTRODUCTION

In May 2009, the Department of Business, Enterprise and Regulatory Reform (BERR), now the Department for Business, Innovation and Skills (BIS), invited the Institute of Chartered Accountants in England and Wales (ICAEW) to undertake independent research into the lending climate for small and medium sized businesses (SMEs) in the UK. The research was commissioned to provide additional insight into the impact of the economic downturn on this particular sector and to provide the government with an 'on the ground' view of bank lending policy.

The ICAEW commissioned Ipsos MORI, an independent market research agency, to conduct this work. The research was carried out through a series of qualitative in-depth interviews with senior partners within the largest 40 accounting firms with responsibility for SME issues. Twenty six respondents were asked open-ended questions, with each interview lasting between 30 minutes and one hour.

The respondents had on average 15 – 20 years experience within the SME sector and typically dealt with 15 SMEs per month across a broad range of economic sectors throughout the whole of the UK, although views on the smallest businesses (in terms of turnover) are probably under-represented.

For the purposes of this study, the term 'SME partners' will be used to refer to these respondents.

While the views expressed by respondents are subjective, they provide a good barometer of the experiences of around 400 SMEs over the course of the last six months as well as an informed perspective on the broader economy.

Additionally, three interviews were conducted with partners of firms that audit retail banks in order to get a rounded perspective. All respondents were from the 'Big Four + 2' firms and have a combined experience of over 60 years. The findings are reported separately and should be treated with due caution as they are based on three interviews only. For the purposes of this report, they will be referred to as 'Bank Audit Partners'.

A full list of participating firms is included as part of the appendix to this document.

# EXECUTIVE SUMMARY

## DIFFICULTY IN ACCESSING FINANCE

All accountancy partners interviewed believed that their SME clients are finding it harder to access capital, but opinions vary as to the severity – from 'fairly difficult' all the way through to bank lending having 'come to a standstill'. While this is experienced by all sectors, SMEs in construction and property, and to a lesser extent those in retail, are seen to be hardest hit. Some, but not all, respondents thought that the smallest SMEs are most affected.

## INCONSISTENCY BETWEEN DIFFERENT BANKS AND EVEN WITHIN BANKS

Banks appear inconsistent in their lending practices. Marked differences in lending decisions and approaches were reported between relationship managers and head offices within banks. As a result, there is no consensus as to whether certain banks were less likely to provide finance than others, for example both Barclays and RBS were praised and criticised.

In general, not surprisingly, most respondents felt that the banks have become a lot more cautious in the way they assess credit applications from SMEs.

## CONFLICTING PRESSURES AFFECTING DEMAND FOR CREDIT

Demand for credit is pushed up by reduced SME turnover, as a result of generally poor economic conditions. However, against this, demand has been pushed down by SMEs cutting back expenditure and by businesses avoiding engagement with their banks out of a 'fear of approach'. SME partners stated that businesses were inclined to 'keep their heads down' out of a fear that approaching lenders would trigger increased bank charges.

## A DAMAGED RELATIONSHIP: SMALL BUSINESS AND LENDER

Before September 2008, the relationships between SMEs and their banks were felt to be fairly healthy. Since then, they have become increasingly strained. This is largely believed to be the fault of the banks being less supportive and existing direct relationships weakening, for example as branch managers' decisions on funding are countermanded by head office.

Banks are now treating new clients cautiously, and are becoming more stringent with existing clients. This is, in part, a recognised effect of the impact of reduced residential and commercial property values for assets held as security and an increased risk profile for businesses generally due to the recession. Many of the respondents believe that banks are now beginning to call SMEs on breaches to lending conditions much more frequently, and with more severe consequences.

The majority do see some discrepancy between what banks say they will do and what they actually end up doing in their dealings with SMEs. This appears to be mainly due to a tension in decision making for funding approval between relationship managers, credit committees and head office. A minority however, reported that banks are being quite straightforward and reasonably understanding in the current context.

## THE IMPORTANCE OF SME FINANCIAL MANAGEMENT

Views are divided as to how good SMEs are at helping themselves. Some feel they are already doing a lot, but others are concerned that they are not good at financial planning (due to lack of time and poor internal financial reporting) and should take more advantage of advice from professionals.

When approaching their advisers, SMEs are most likely to request increased assistance in predicting cash flow and trading as well as for balance sheet forecasting and help preparing business plans to support credit applications. To a lesser extent, various other types of advice are asked for, including help with cost-cutting, insolvency planning, tax planning and general business support. Significantly, the main reason for all forms of advice seems to be to help the business survive rather than to expand or invest.

## GOING CONCERN

Being judged a 'going concern' is a major SME company problem. It can cause audit issues and is a significant worry to a minority of SMEs. The majority of respondents reported that a significant minority of their clients would be subject to going concern uncertainty, generally up to around 15% of the client base. A very small number of respondents put the level of failure rather higher (20 – 35%). Such figures suggest that the number of going concern modifications in 2009 will be considerably higher than in previous years. Failure is mainly ascribed to external factors (the economy and having fewer customers) but a minority also blame internal factors such as lack of management skills within SMEs being exposed by the harder economic conditions.

## MIXED VIEWS ON THE COST OF FINANCE

Some feel the cost of finance is too high due to high bank fees and an increasing link to LIBOR rather than the base rate for the cost of borrowing. Others – while acknowledging that banks are making higher margins – feel that the price is now recalibrating to a more realistic level, having been too low for quite some time, and now properly reflects the lending risks.

## LOW AWARENESS OF GOVERNMENT SUPPORT

Most SMEs are not thought to be aware of the government-supported 'health-checks'. Awareness of government schemes to support access to finance is also thought to be low and the schemes are thought to not be very accessible. There is a perception that current government schemes do not operate effectively together 'as a whole', including the marketing and awareness-raising effort for those schemes.

## FUTURE SUPPLY OF CREDIT

The majority of respondents expected the supply of credit to increase within the next three to twelve months. None expected it to fall.

## SMES NEED A COMPETITIVE ENVIRONMENT AS WELL AS ACCESS TO CREDIT

Reducing company taxes and forcing banks to lend to viable SMEs on reasonable terms are the most popular suggestions for the ways in which government can help, followed by a more proportionate approach to small business regulation.

# ICAEW POLICY RECOMMENDATIONS

The research points to a number of specific steps that could be taken, on the part of banks, government, and the accountancy profession, in order to help SMEs weather the current downturn. While these recommendations require the banking sector to take a lead, it is critical that government, the banking industry and the accounting profession work together to help resolve these issues in the months ahead.

## COMMIT TO TRANSPARENCY AND CONSISTENCY

Banks should improve their relationship management with businesses and their advisors. Restoring trust between banks and their clients will require a commitment to transparency and consistency on the part of lending institutions.

It is clear that some banks have re-appraised their risk and reward preferences for SMEs. Banks need to address the consequential 'fear of approach' held by businesses by clearly explaining how the changed economic environment has affected banks' business lending policies. In particular, they should make a sustained effort to better communicate with businesses at early stages in the lending application process to improve understanding of the following:

- How long credit applications are likely to take
- What restrictions on decision-making are imposed on relationship managers and branch managers by head office and whether specific decisions will be transferred to higher levels
- How many credit committees will examine the application
- The full extent of non-price lending conditions
- The enforcement regime for covenant breaches
- How much financial information will be required from the SMEs, including whether management accounts will be required on a monthly basis rather than quarterly or bi-annual basis

Within banks there needs to be greater consistency of SME lending practices. Greater transparency in communicating the credit application process, as detailed above, may help to address inconsistency by publicly managing expectations towards a consistent approach to lending.

## PROMOTE ALTERNATIVE FORMS OF FINANCE

Banks should adopt a more holistic approach to helping businesses access appropriate forms of finance. Banks need to be more proactive in creating awareness of complementary forms of debt finance or asset-based lending (ABL), where appropriate for the business, together with the associated legal, financial and operational implications for that business.

ABL includes invoice discounting and debt factoring and other forms of asset-based finance, where an organisation borrows money against their property, plant, machinery, stock, or sometimes even their brand name. ABL can be an appropriate alternative to bank loans and overdrafts for relieving pressure on cashflow or for funding business needs such as capital purchases or financial restructuring. ABL is not generally dependent on the existing profitability of a business and, compared to bank loans and overdrafts, can support business growth without imposing additional banking restrictions on a business.

## STRENGTHEN THE APPEAL PROCESS

Banks should strengthen their appeal processes for lending and effectively communicate those processes to their credit applicants. For difficult decisions, particularly those involving existing clients, the appeals process should include an option to use an independent mediator with expertise in corporate finance.

## ADDRESS THE BREAKDOWN IN RELATIONSHIP BETWEEN BUSINESSES AND LENDERS

Government has a role to play in helping to address the breakdown in the relationship between small businesses and lenders. Improving the understanding of existing appeal systems is a public interest issue. The government, the accountancy profession, and lending institutions need to work in partnership to promote awareness of appeal structures within the SME community.

The government should also consider introducing a new and streamlined external appeals mechanism, ideally operating through an existing structure such as the Financial Ombudsman Scheme, available after a bank's internal appeals procedure had been exhausted. The ICAEW understands that credit mediator proposals to independently evaluate lending decisions have had initial success in both Belgium and France. The UK government should examine these proposals to determine whether they could better support the credit environment in the UK. For such a proposal to be effective, businesses would need their appeals to be processed relatively quickly and this premium on speed may require the use of an independent mediator. The government should also determine the viability of a voluntary scheme in order to reduce the regulatory cost and bureaucracy of such a proposal, as well as, potentially, the speed of decision making.

## INCREASE TRANSPARENCY BY PUBLISHING REGULAR LENDING DATA

Comprehensive and independent data on lending (across sectors, regions and sizes of applicant) and take up of public finance schemes is required to advise public policy in this area. Current arrangements fall short of this requirement. Government (BIS) press releases on the issue are irregular and other data on bank lending is limited to total aggregate lending, either through the Bank of England or the British Bankers' Association. The ICAEW believes that it would better inform the public policy if statistics on lending, including Enterprise Finance Guarantee take-up, were made publicly available on a regular basis.

## HELP IMPROVE GENERAL LEVELS OF SME FINANCIAL MANAGEMENT AND AWARENESS

There is a role for government in raising awareness about the importance of financial management as part of public policy efforts to improve access to finance. This might include the following:

- Highlighting that evidence of sound financial management is essential when approaching lending institutions
- Raising awareness of the range of finance options available to SMEs and the broad advantages and disadvantages of the various types of finance, including equity
- Improving understanding of lending conditions and terms, including personal guarantees and security and loan covenants
- Signposting wider sources of financial advice
- For those micro-businesses and start-ups without in-house financial expertise, the government should emphasise the value and importance of seeking independent high-quality financial advice

In addition to better supporting existing businesses, improving levels of financial management is critical to strengthening the likelihood of entrepreneurial start-up success.

The UK government has had some success in raising awareness of many of the issues referenced above through the Finance and Grants theme of the businesslink.gov website and through the Best Practice Guideline on SME Finance produced and published jointly by BusinessLink, BERR and the ICAEW Corporate Finance Faculty. Our research indicates that more needs to be done.

## BETTER COMMUNICATION AND AWARENESS OF GOVERNMENT SCHEMES TO SUPPORT ACCESS TO FINANCE

Government should continue to improve awareness of publicly-funded schemes to support access to finance and better manage SME expectations. For the Enterprise Finance Guarantee scheme, this should include better communication about the fact that lenders may require security, including personal guarantees and that the overall cap on public exposure to bank claims brings significant risk to the bank in the credit facility. Such awareness would help address SME disappointment and misunderstanding of the conditions of the scheme. Arrangements should be simplified wherever possible, descriptions clarified, and requests for information from businesses minimised.

## PREPARING FOR FUTURE DEMAND FOR CREDIT

While much of the focus in the SME access to credit debate has centred around the supply of available finance, there is evidence to suggest that companies have been reluctant to make requests for additional finance from banks in recent months due to general economic uncertainty. As businesses reach their credit limits and as efforts to cut costs, manage working capital, and reduce capital expenditure reach their limit, demand for credit is expected to increase.

Government therefore needs to be alert to the possibility of a release of pent-up demand for credit over the next 6-12 months. With supply-side finance issues increasingly at the fore, public policy in this area will again be under pressure. The government's assistance with access to finance needs to be well prepared for an upturn in demand for credit, including addressing the marketing and the promotion of financial management skills issues outlined above.

The ICAEW recommends that the government establishes an advisory body to look at wider working capital management issues, including credit management, credit insurance and also working capital finance, and examine the appropriate public policy response to those issues in preparation for an upturn in demand for credit.

## IMPROVING THE BUSINESS ENVIRONMENT

Respondents called on the government to improve the business environment, in parallel with efforts to improve access to credit. The ICAEW believes that encouraging prompt payment is a key element of the effort to improve the business environment for SMEs.

Late payment of commercial debt is a recurring issue that businesses and advisory firms report back to the ICAEW. The government has already done much in this area, including introducing the Late Payment of Commercial Debts (Interest) Act 1998 which entitles businesses to charge interest on overdue payments, as well as recovery of collection expenses and, more recently, publishing a series of credit management guides with the Institute of Credit Management. The government has also introduced the Prompt Payment Code, encouraging large businesses to pay suppliers on time, give clear guidance to suppliers and encourage good practice. The government has itself introduced a pledge to make payment of trade invoices by government departments within 10 days.

However, more needs to be done. The ICAEW recommends that regular statistics are published on the performance of local government bodies and government agencies, as well as central government, in meeting the 10-day payment pledge. We also believe that the Better Payment Practice Group, disbanded in March 2007 by the Department for Trade and Industry (DTI), should be revived. The group was effective in maintaining prompt payment as a key agenda item for a diverse range of stakeholders – the government, banks and other lending institutions, business bodies, the accountancy profession, and the credit reference agencies. The original group was supported by a PR agency (funded by the DTI) which enabled the publication of regular articles in member body communications to the SME sector and in the media, improving SME understanding of their rights and best practice with addressing late payment.

# MAIN FINDINGS: SME ACCOUNTANCY PARTNERS

Where specific quotes have been drawn from interviews the size of firm has also been indicated. 'Big Four + 2' refers to the six biggest firms in the UK. Group A refers to the top 20 firms outside of 'Big Four + 2'. APA (The Association of Practising Accountants) refers to APA members, independent medium-sized firms of accountants mostly across the top 20 to 60 largest firms in the UK.

## DIFFICULTY IN ACCESSING FINANCE

The respondents' overall view is that SMEs clearly have difficulty obtaining financing, but opinions vary as to whether it is merely fairly difficult to almost impossible. Some consider that funding is still available for 'good' businesses but that there are a lot more hurdles to overcome now, with banks being much more risk-averse. However, if an SME has a good relationship with its bank, financing may be available, but typically with the banks increasing their margins for new financing. Others consider that it has now become very difficult indeed for SMEs, especially for new customers and certain sectors.

A small number of respondents mention certain banks as being particularly difficult to work with, but the majority would say that all of the banks are simply not lending as much. When the banks actually are lending, low base rates mean the cost of financing is lower than it has been in previous years, but banks are now charging higher margins.

> *'It's fair to say it remains difficult. Funding is patchy and the banks have clearly taken a more cautious view to lending,'* – Big Four + 2

> *'SMEs are currently a captive market, and are seeing that margins have been going up. Everything is currently being based on Libor, as opposed to the Base Rate.'* – Group A

> Some would even go so far as to say that financing for SMEs has '*virtually come to a standstill.'* – APA

> *'It's now more difficult for businesses to obtain new funding. Some are being called in for renegotiation, others have to renegotiate when they have need for additional funding. Covenants are being looked at much more closely now.'* – Group A

> *'Banks are now much stricter, more risk-averse, and more expensive.'* – APA

> It is *'harder because banks are managing their own exposure. SMEs can be staring into the abyss because of the bank's mistakes rather than their own.'* – Anonymous

When discussing their own clients (SME clients), the responses cover quite a range of experiences. Respondents generally reported that a majority of their clients are having difficulty raising finance

> *'Being in retail, most of my clients are having some difficulties with the economic situation causing less and delayed spending by customers resulting in cash flow problems.'* – Group A

> *'70% experiencing difficulty but 85% are worried'* – Big Four + 2

Most respondents with SME clients who are having difficulty getting financing from banks, think that they are mainly viable.

> *'80% of these are viable and for many the only reason they're not viable is because they can't raise bank finance!'* – Big Four + 2

Some of our respondents indicate that just a small number of their clients are having difficulty raising finance:

> *'About 15-20% are having difficulty raising finance, most have already had to batten down the hatches.'* – APA

> *'Very few of my businesses would have difficulties raising finance but this is also due to the fact that facilities have not yet come around for review – there is certainly some trepidation.'* – APA

Others say that a general lack of difficulty is because very few of their SMEs are actually looking for finance at the moment:

> *'Most of our clients are not looking to raise finance, so few difficulties, although 10-15% are close to or at their limit, so they are re-negotiating at the moment.'* – Group A

*'All clients that are trying to get finance are having difficulty, but only a few are trying to get it.'* – APA

*'There is a large sector of SME market that is surprisingly unaffected. People who have always funded their business out of cash-flow and don't have need for working capital.'* – APA

While some respondents say that difficulty is 'across the board' (APA), most think some sectors are finding it even more difficult; especially property, construction and, to some extent, retail sector (depending on what type of retailer).

*'It's much harder for property, construction, and retail, especially small retail boutiques'* – Big Four + 2

Opinions vary as to the role that an SME's size plays as a factor in obtaining financing. Some felt that it made no difference and depended just on how well the SME was managed, its track record with the bank and how good (or bad) a position it was in financially. However, larger SMEs were more likely to have a solid track record and therefore be able to obtain finance more easily.

*'It's about the quality and approach to management rather than the size of business'* – APA

Others felt that the smallest SMEs found it the most difficult.

*'Larger SMEs who have larger debt are probably in a better position. Smaller SMEs who have reasonable debt and have managed it better get treated worse'* – Group A

Before last September and the collapse of Lehman Brothers, most believe that the general state of financing for SMEs was very stable.

*'Before Lehman collapse SME financing had been fairly stable with perhaps some increases.'* – Group A

*'During this period the banks wanted to ride the expanding economy and were desperate to lend, at silly rates.'* – APA

There are a handful of respondents though, who started seeing signs of a slowing economy 6-12 months before last September. Some banks were being more cautious and starting to reconsider their approach to financing.

*'It was difficult to get money out of HBOS well before Lehman.'* – APA

*'Not a year before Lehman, but a few months before, banks were starting to change their attitude.'* – APA

*'It was worsening before Lehman, then it became dire.'* – Anonymous

Regardless of the views on supply or demand before the collapse of Lehman Brothers, there is a resounding belief among respondents that, since last September, the supply of financing for SMEs has decreased.

*'The impression is that there is no appetite to lend, even though the banks assure us that they are 'open for business'. Sometimes it can seem as if they are talking to us simply to see if they can secure some deposits. There seemed to be a patch where there was more enthusiasm, but that has largely dried up.'* – Anonymous

*'Fear is causing it. The banks overstepped themselves a great deal a few years back and most businesses were given finance if requested. Two years ago was much easier than ten years ago. Banks got more competitive with each other to provide finance, but since found that it wasn't a good model. They were so competitive and undercutting each other, offering all sorts of credit lines and are now pulling back on it. But there are now decent businesses that are being left high and dry as the banks pull back.'* – APA

*'Banks are looking very very critically at the clients they have, the sectors they are in, and are they the sectors that the bank wants to be involved in? If they're not, then the banks really don't want those customers in the future.'* – APA

A majority of the respondents also say that over the past year, banks have become much more cautious by modifying the criteria they use to determine whether or not an SME is actually eligible to obtain financing.

*'Banks will now take less risk. The key thing is strong management with a good, realistic business plan including scenario planning.'* – Anonymous

*'Before Lehman you would have the line manager going to one committee before agreeing financing, now they have to go to three committees.'* – Group A

*'Changes in criteria used by banks are: One, they are looking at security cover far more. Two, they are looking at security generally harder. They are less likely to lend against short term leases for example.'* – Anonymous

*'Yes, noticeably so. Financial information that SMEs have to provide to the bank has increased. For example, management accounts, which would have been reported quarterly or bi-annually, are now moving onto a monthly basis. Financial covenants used to be somewhat overlooked, but now have to be checked, spelled out, and returned.'* – APA

Some respondents consider that the banks are most concerned with increasing their own capital.

*'Banks are trying to improve their position by whatever means.'* – Anonymous

This means becoming more risk-averse, by changing how they deal with secured lending:

*'Secured lending – if you already have an agreement with a bank in place, then you're absolutely fine. It is when you come up to the end of your term, then things are different at the moment.'* – Group A

*'There has been a slightly schizophrenic attitude by the banks with regard to secured lending. They are looking for more but I've heard several say that if covenants are being breached then they need to be re-written – they were written at a 'mad' time and they don't want to lose credibility.'* – APA

*'Secured lending has been increasingly asked for and conditions are often being tightened. For example I know that some banks will now only advance up to 70% of valuation on commercial property.'* – Group A

## INCONSISTENCY BETWEEN DIFFERENT BANKS AND EVEN WITHIN BANKS

There was no clear consensus as to whether financing differed between the various banks. Some felt that they were all treating SMEs in a similar fashion. Others noted that certain banks were less likely to provide finance than others but there was no clear agreement on who were the worst culprits or the easiest to deal with. Some mentioned RBS and Lloyds as being more difficult and Barclays easier, whilst others praised RBS and criticised Barclays. A minority felt that banks differed greatly in their approach and consistency from week to week.

*'RBS appears to be getting its act together. They are worth talking to (about funding) at the moment.'* – APA

'*RBS – the most obnoxious and disorganized.'* – Big Four + 2

*'Biggest problem I have is with Barclays and their 'take it or leave it attitude'. They believe they are untouchable.'* – APA

Most of the respondents tend to think that the bailed out banks are behaving in a similar manner to the rest of the banks in terms of how they address SME financing and are not consistently lending more.

*'Bailed-out banks seem to be acting the same as other banks. When you speak to any bank at the moment they claim that they are open for business, but often aren't in practice.'* – Group A

*'They are all behaving in a similar way, but hopefully moving forward, the banks with public money will start to lend more.'* – Big Four + 2

However, a few respondents do mention that 'bailed-out' banks are behaving slightly differently.

*'Lloyds and RBS are the worst; they often act with no understanding or compassion and destroy the trust and loyalty built up over very long relationships. Barclays and HSBC are better, but still now much more difficult than previously.'* – Anonymous

The type of funding required also plays a role, more secure asset-based financing generally being considered to be easier to get as it is seen as less risky with banks wanting security.

The respondents express mixed feelings when it comes to how banks are dealing with conflicting pressures to use government money. Some are saying that the banks are using the government money to boost their own capital ratios:

> *'Initially I thought the banks could be more helpful than they have been. I tend to believe that they needed to balance their balance sheets, which means it comes across as unbalanced in their favour.'* – APA

While others say all the banks are feeling the pressure, not just 'bailed out' banks:

> *'All banks are remanaging their risk not just Lloyds and RBS. All are in the same boat. [It] depends what you mean by managing well. All banks are being cautious'.* – Anonymous

There was some concern that the pressure to lend was conflicting with the greater caution of the banks.

> *'One client with business profit of £6m had no joy from RBS re refinancing but he rang a contact within government who contacted RBS and the refinancing went through'.* – Big Four+ 2
>
> *'The pressure to start lending is not having much effect'* – Group A
>
> *'I haven't seen any significant increase in the funding being made available to SMEs as yet. There does appear to be an appetite on the part of banks to do a deal but the deal often stalls.'* – Group A

A minority felt that some banks were in a very difficult position balancing the financial and political pressures.

> *'They are in an invidious position but they put themselves there so I don't have any sympathy for them'* – Group A
>
> *'Banks are in a bit of cleft stick.'* – APA

## CONFLICTING PRESSURES ON DEMAND FOR CREDIT

Opinion is divided as to the level of demand, either that it has increased because other pressures have reduced working capital or that it has actually fallen because SMEs are trying to avoid approaching banks by controlling their costs.

> The first view indicates a *'higher demand, especially in retail where fewer customers walking through door causing greater need for working capital.'* – Anonymous

Simply put:

> *'There is a demand right now that needs satisfying.'* – Group A
>
> *'More SMEs need cash-flow funding because turnover has fallen and it could take them two to three months to reduce their costs and because the SMEs' customers are taking longer to pay them.'* – Anonymous
>
> The alternative view suggests that *'demand is pretty much non-existent.'* – Group A

Some respondents say demand has decreased due to SMEs wanting to avoid banks and because SMEs are finding financing through alternative means.

> *'They avoid having to go to the bank.'* – Big Four + 2
>
> SMEs do this by *'cutting back. Every company is trying to collect debts quicker and pay suppliers more slowly.'* – APA

There is also some evidence of differentiation by sector though, and again we see the usual mentions of property, construction, and retail.

*'Property is again the exception where decline is much greater. House building has stopped as builders can't sell the houses. Developers are pulling back due to lower demand'* – Group A

On the other hand, we have *'retail and supply-chain going into retail (non-food) are under pressure so they are demanding more.'* – Big Four + 2

## A DAMAGED RELATIONSHIP: SMALL BUSINESS AND LENDER

Before the start of the economic downturn, most of the respondents believe that relationships between SMEs and banks were fairly healthy. However, since last September, the relationships have been increasingly strained and complicated. In the eyes of the respondents, the fault with the current state of the relationship lies mostly with banks, but is also attributed somewhat to the SMEs themselves.

*'The relationship is not good, but in a particular light. The relationship for SMEs is very limited because the amount of business they provide to the bank – therefore it is merely a functional relationship.'* – Big Four + 2

*'Those who need funds don't see banks as supportive and those with funds are nervous about security of savings'* – Anonymous

*'There could be better information provided to banks and…banks could be giving more advice to clients.'* – Group A

*'Relationship managers, and people further down the chain, used to be able to give you a good idea whether financing was going to be approved by the credit committee etc. Now it seems that a relationship manager won't have much influence, or really know whether financing will be permitted until they get an answer back from the credit committee.'* – Group A

*'Before you could get lucky and get a really good bank manager. They knew how SMEs worked and would try and work the bank's parameters to help the SME – but that was very much down to the individual.'* – APA

*'Banks are good at talking about relationships, good at trying to sell services on back of relationships, but not good at delivering goods at the right time. SMEs need it when times get tough.'* – APA

Very few felt that the relationship was unchanged or had even improved, for example by reporting banks being very supportive of existing clients.

Because of this situation, banks are now treating new clients cautiously, and are becoming more stringent with existing clients. This can be seen through the way services and facilities for financing are managed.

*'Banks want to move from base-rate basis to Libor basis, and will use technical breaches of covenant to drive this through.'* – Big Four + 2

*'Credit applications – one of our clients is still waiting 5 or 6 months on from the application. More information is needed before banks will move forward, there are more internal checks done and you often end up going through the credit process several times before you get an answer.'* – Anonymous

*'It's very difficult to refuse renegotiation as most are repayable on demand. The bank has the upper hand.'* – APA

*'We have examples of clients being promised answers within 48 hours and then having to wait three weeks.'* – Group A

*'Waiting times for credits have dramatically increased. It takes longer to get the offer and then the banks will sometimes attach a very short shelf-life to the offer, say only 14 days, after which it will lapse. It is sometimes not possible to arrange transactions within that timescale, like, say, buying a farm for example, and then when deal has finally been completed the offer may no longer be there. This problem is probably not as bad now as it was 4/5 months ago.'* – APA

Many of the respondents believe that banks are now beginning to call SMEs on breaches in lending conditions, and they are doing so much more frequently, and with more severe consequences.

> *'Banks pick up breaches much quicker. An unplanned breach rings warning bells and puts SMEs in the spotlight. Some SMEs stick head in sand. Better for SMEs to avoid false crises by warning the bank if there is to be a problem.'* – APA

Also many respondents consider that the banks use breaches as a reason to increase charges.

> *'Banks are more strict now on following up breaches in covenants and may use them as a reason to renegotiate lending conditions.'* – Group A

> *'Using it as mechanism to increase fees and increase rates. They're not trying to call in the loan, as that would be counter-productive all-round. But as long as the business has a viable future – they will extend finance, but at higher rate and higher fee for that breach.'* – APA

However, a minority regard some banks as being understanding. They will be more wary of breaches than they used to be but will not automatically react harshly.

> *'In my experience they don't worry about it. Some banks require management accounts within X days of the period they relate to. Invariably that doesn't happen with many clients and I've never heard of a bank foreclosing on the loan because a particular deadline hasn't been met.'* – APA

The majority are seeing a discrepancy between what banks tell SMEs and what they then do, most often between what the relationship managers says about providing greater finance which is then rejected by their head office, regional offices, or credit committees.

> *'What the relationship manager tells you won't be the same as what the credit committee of the bank will decide to do… They have to admit to their customers they don't know what their bank will do'* – Big Four + 2

> *'Quite a lot – tell them they'll be nice, then they're not'* – APA

> *'We have had examples of a bank's relationship manager agreeing deals with clients but when these deals have been taken to the bank's internal credit department they have failed to endorse them.'* – Group A

Only a small minority feel that the banks are being straightforward in their dealings with SMEs.

> *'Banks tell it how it is – they're upfront on this. What worries SMEs is an unexpected call from the bank's 'close care' dept'* – Big Four + 2

> *'I've seen no differences here. My clients discuss requirements with relationship managers but will understand that the bank's internal credit committees have to approve things before anything can happen.'* – Group A

## THE IMPORTANCE OF SME FINANCIAL MANAGEMENT

Opinion is divided as to how much SMEs can do to help themselves – some clearly think they can do more whilst others think they are already doing a lot themselves. There is some concern that SMEs are not always good at financial planning (e.g. due to lack of time caused by crisis management, by being weak on paperwork and financial planning, etc) and should take more advantage of the available advice from financial professionals.

> *'The owners/directors should recognise that they have responsibilities to their company, their shareholders and employees, their stakeholders, and I don't think some of them do.'* – APA

> *'As always, they have to look at their own business model again. They've got to look at their processes again.'* – APA

> *'They could be more efficient. They're entrepreneurs and tend to be weak on paperwork and tend to take an historic view rather than a forward-looking one. They could keep more up-to-date with quality information, which often they don't use. Then they would know more about where the business was likely to go and be able to plan better.'* – APA

SMEs are most likely to request more assistance in predicting cash flow, forecasting and making projections. Various other types of advice are asked for to a lesser extent, including on cost-cutting, insolvency planning, tax planning and general advice.

But the main reason for all forms of advice seems to be to help them survive.

> *'More companies are asking for help with basic accounting difficulties, particularly with profit and cash flow projections. I think there is a greater need for basic accounting skills in bad times. Banks in particular want projections in much more detail now as well as regular management information not previously requested.'* – Group A

> *'The service we're providing our SMEs is wide-ranging advice.'* – APA

## GOING CONCERN

Being assessed as a going concern was felt to be a major SME issue by most respondents to a greater or lesser degree.

> *'It is a big issue, but probably because it isn't something they have had to worry about. It's an issue because they might not be aware of all the requirements necessary to provide to auditors.'* – Group A

> *'It's a very big issue now and will be over the next 12 months.'* – Big Four + 2

It also causes audit problems.

> *'It is an issue for audit reporting. We have to make judgements on going concern issues now (May 2009) for accounts prepared to Dec 2008 and these judgements are for a twelve month period from our signing off. I.e. forward to May 2010. So we have to qualify the going concern statement by adding that our judgement assumes the bank will continue to support the client as they do at present. The banks are very 'woolly' on this.' – Group A*

> *'The most important issue – as auditors it's our highest risk'* – Group A

A minority felt it was a very major concern for some of the SMEs they deal with, causing them considerable worry (e.g. because they could be removed from government tender lists).

> *'It's going to be a real issue for those that require an audit. Because if you're providing an audit certificate, and there's a concern – and the banks are still in debating with the client about whether the overdraft facility is going to be renewed – then attention is being drawn to the fact that the SME may not be a going concern, it's a real issue for them.'* – APA

> *'This is a topical issue that auditors have to resolve. We like to see a facility renewal letter from the banks giving us some comfort that credit facilities will continue or be renewed over the next 12 months but banks are much more reluctant to do this now. So, we have to put some sort of clause into the audit report saying our going concern decision is made on the assumption that the banks continue supporting the client over the next 12 months, as at present. This sort of qualification clause can have other detrimental effects on the client's business, such as making credit insurance on goods it purchases more difficult.'* – Group A

However, a few feel that it is now becoming less of a problem.

> *'The reports don't actually matter THAT much now. They matter, but they are not an indication that the company is not a going concern as it may have been in the past.'* – APA

> *''Going concern' is a very relevant subject but the work I've done suggests that going concerns would be signed-off. My perception is that 2008 was a 'game of two halves'. For the first 6 months trading was good, then trading fell off a cliff but over the full 12 months many did OK, so when they completed their 2009 projections some expected to fall far harder but many have performed far better, so I don't think it's an issue.'* – Group A

Most consider that the judgement relies primarily on projections over the next 12 months, but a minority cite other factors too (existing balance sheet, past experience). Also a minority point out that it is just a projection and not a firm prediction.

*'We do, of course, always get forward projections to use in making 'going concern' judgements.'* – Group A

*'The real key is, have you got the cash resources. Have you got facilities in place that you can draw on.'* – Big Four + 2

*'It's based on a bit of everything; past performance, the current situation and realistic projections. It incorporates working capital requirements, scenario planning, possibility of covenant breaches, etc.'* – Big Four + 2

*'We won't sign a going concern declaration unless we have a meaningful projection going forward. But, a projection is just a projection.'* – Group A

*'As to how we form that judgement it depends on the nature of the client, on past experience.'* – APA

The majority felt that fairly few of the SMEs they deal with (from 5% to 15%) would fail the test, but a small minority (three out of the 29 interviewed) put the level substantially higher at more like 20% to 35% failure. These respondents are also the most pessimistic about the ability of SME's to obtain finance.

*'Very few of our clients would fail the test but certainly more than a year ago. Often the issues are ironed-out behind the scenes.'* – APA

*'Some colleagues say all clients are failing going concern.'* – Big Four + 2

*'All clients are having to do more to prove they are going concerns but the majority of my clients have no real problem with this.'* – Group A

*'Around 20%–30% have material uncertainties.'* – Big Four + 2

Where they have an opinion, the majority feel that external rather than internal factors have had the greatest impact, i.e. the economy, fewer customers. A minority also feel that internal factors such as a weak business model have also played a role.

*'I think external factors have had the greatest impact. Some really solid businesses are seriously affected almost overnight so I don't think its internal factors so much. It's economy driven, confidence driven, external factors.'* – Group A

*'When the economy is growing you can often grow even if your business model is not particularly robust or management skills are lacking but it is much more difficult in times like these. So, internal factors do sometimes impact on 'going concern' failures. However, I believe external factors, the economic situation, have a much greater impact. The introduction of IFRS has also exacerbated the situation with companies having to write down previous asset values, affecting bottom lines.'* – Group A

*'In general I believe external factors have a greater impact and banks are probably contributing a large part of this.'* – Group A

## MIXED VIEWS ON THE COST OF FINANCE

The cost of funding is generally considered to have increased. The general consensus is that banks have increased charges at the same time as the base rate fell so that companies have seen no benefit from the falling rate. Also lending is increasingly linked to LIBOR.

*'Every type of charge has gone up dramatically'* – Big Four+2

*'Absolutely. The pricing of debt arrangement fees have all got higher and the covenant regimes got tougher.'* – Big Four + 2

When discussing the current cost of credit for SMEs, respondents tend to agree that the price is either about right or it is too high, but this is due to the fact that bank margins and the price of risk are much higher than they have been in many years. There are some, however, who say the price was too low for quite some time and now what we are seeing is perhaps the beginning of a road to normality.

*'Price of credit not really too high, as base rates are so low, but banks are taking higher margins. Risks certainly over-priced.'* – Big Four + 2

*'Cost of finance is high in relation to what people can earn.'* – Group A

*'Interest rates are lower now but cost of credit is higher. One-off fees are much higher.'* – Anonymous

*'Too high. It reflects the cost of their borrowing from the government.'* – Group A

*'I think the price of credit is about right. The big problem is that SMEs don't properly understand how it's priced. Lloyds did a very good presentation on this recently… which would have been very helpful for SMEs.'* – APA

*'I don't think it's necessarily wrong. I think banks got very competitive and cut their own margins. I think as always, it will vary from case to case. I think some of them, at the extreme end, have increased their margins too much.'* – APA

*'Over the last five to ten years the cost of borrowing has come down, it had become too cheap. I'm not sure about the current prices but I do think there is some bank profiteering.'* – Group A

*'Personally I think the price of credit is far more realistic than it has been.'* – APA

There are many reasons contributing to the current cost of finance, but by far the most prevalent response was simply that banks want to increase their margin in an effort to boost profitability.

*'Purely to correct the balance sheet. All costs are up.'* – Anonymous

*'Banks are trying to make the most money from what they have got. If they have a freeze on new lending, you'll get no money that way. With portfolio clients, they make the most of what they have got. It's there, you've got to deal with it and make the most from it.'* – APA

*'The main reason for the change in finance costs is due to changes in the base and LIBOR rates and the fact that banks need to re-group on their balance sheet.'* – Group A

*'From what banks have told me, the driver of that change has mainly been the need to boost their margins.'* – APA

Opinions vary about the general level of the lending rate – LIBOR versus the base rate. The most frequent view is that it is mainly at or close to LIBOR, but others think it depends on the size of the loan, and a minority that it is closer to the base rate (base rate +). A few see signs that it is falling back from LIBOR levels.

*'Tendency to switch to Libor – decreased now that Libor had come back down. Bit surprised that they bought back to base. Libor is a better measure of cost of finance to the banks. If banks are managing their loans/ costs of finance properly – Return on Finance, then pricing off Libor is better way of doing it.'* – APA

*'Banks are exploiting the situation to get back as much as they can.'* Big Four + 2

## GOVERNMENT SUPPORT

A majority of the respondents think that the government should focus on SMEs across all sectors and not on any particular sector.

*'The British economy is made of many sectors, it is difficult to argue the case for one sector above another.'* – APA

*'We should support all SMEs, they are responsible for a big part of the country's GDP.'* – Anonymous

*'No because all parts of the economy are affected. Any more detailed intervention is likely to generate much red tape.'* – Group A

*'It's hard for the government to focus on particular sectors, if they were to do that you could argue the case for each and every sector.'* – APA

However, some respondents mention certain sectors that the government should focus more on – and one of the more common responses was the retail sector.

> *'Yes, they should focus on the hardest hit sectors – retail and the retail supply chain. Because it's hard for these businesses they're 40-50% down on like-for-like sales.'* – Big Four + 2

> *'Yes but not sure how. Retail needs the most support. Property companies can re-gear and will correct after the dip but retail can't do this.'* – Anonymous

> *'They could perhaps focus on retail and on those sectors which have a less sophisticated understanding of financing and the options available to them. In comparison the financial services sector will sort itself out.'* – APA

And we also see an even smaller group of individuals who think that the government should not focus on SMEs at all.

> *'I think there should be as little Government intervention as possible, as a rule. Let the market take care of itself.'* – Group A

> *'No. The Government has a duty to support the economy in its totality, accommodating all sectors alike'* – APA

The majority opinion is that the government should not get involved in helping SMEs with good financial management for various reasons – they should be able to manage this themselves, they are not sure how the government could provide this support, there are sources of advice for this (accountants, financial advisers, etc), or that there are better ways to help (less tax or red tape).

> *'No. Not role of govt, role of private sector. Nature of business, if you don't have good financial management you have risks and we are operating in a market economy. Failures are often down to poor FM – government shouldn't get involved.'* – APA

Only a small minority favour government help with financial management.

> *'Yes, I've been involved in this through Business Link and the government health checks which were very useful but it does depend on how it's done.'* – Group A

But most think this is not something government should get involved in.

> *'No. Not role of government, role of private sector. Nature of business, if you don't have good financial management you have risks and we are operating in a market economy. Failures are often down to poor financial management – government shouldn't get involved.'* – Group A

> *'No, this is not the role of government. There is already enough quality help out there if needed. The government could perhaps help towards its cost in some way but not give the advice direct.'* – APA

Most respondents think that SMEs are mainly unaware of the 'healthchecks' scheme.

> *'Not very, and when they are aware – they don't think they serve a great deal of purpose. Rather the govt focussed on less laws and regulations for business and therefore reducing the amount they spend on compliance. It's not direct cost – NI etc, it's the red tape and the diff forms.'* – APA

## CURRENT GOVERNMENT SCHEMES

The general perception is that the government schemes are not very visible and, even if they are visible, they are not very accessible.

> *'I'm not aware of them, nor am I aware of any bank promoting them.'* – Group A

> *'My overview is they're not that visible, they probably would throw that back in my face and immediately direct me to a website or something and say 'What's not visible about that?' I think in my mind, visibility is not only about there being a website about them, it's actually hearing about people using them.'* – APA

> *'Other than reading about the launch, we've heard nothing. Nothing has been sent to my firm and my clients would be sceptical.'* – Group A

*'In the automotive industry, it is reasonably visible/accessible – elsewhere, it's 'patchy'. Many SMEs know about them, but knowing, and getting a hold of them, are quite different things.'* – Big Four + 2

The Enterprise Finance Guarantee and Working Capital schemes are not felt to be very effective (yet). Awareness is patchy and they have not been much used.

*'They're not well known. I've heard that when people try to access them via the banks they are not helpful and talk only to those who have good asset backing.'* – Big Four + 2

*'I'm aware that banks have heard of them but I'm aware that banks don't necessarily know how they work.'* – APA

*'People don't understand them.'* – Big Four + 2

*'The Enterprise Initiative was certainly good. It's too early to say whether EFG and Working Capital schemes will be effective and I'm not sure if they're across all banks'.* – Group A

*'I've seen these sorts of things before and if banks don't like them then they won't push them.'* – APA

*'I think they work if the banks are willing to do it. With the SLG there was a lot of paperwork which bank managers didn't want to do.'* – APA

Most were unsure as to how well government schemes operate together and were unable to give a considered opinion, but where they do have a view it is mainly negative.

*'They have to in principal – but it not something you see.'* – APA

*'Very badly. Lack of joined up thinking, too many government agencies involved. Government hasn't got its head round it. It needs a one-stop shop for these things – all government financing deals. Get it out of all the other stuff government tries, Business Link etc.'* – APA

Respondents mainly feel that it is not practical for lenders to assess whether a business is viable for the purpose of accessing public support schemes or are unsure about this issue.

*'It's not practical. They have a conflict of interest, being their lenders as well.'* – Group A

*'The documentation provided for viability for accessing schemes is pretty good. But banks struggle working out the risks that businesses have or how good/secure the SMEs' customers are.'* – APA

*'I hesitate to say it but I'm not sure how skilled, or independent the banks are to make that kind of assessment. There is a conflict of interest there.'* – Group A

Only a minority think the lenders can do this.

*'Should be very practical. If they're speaking to a SMEs, they should have all the information necessary.'* – APA.

## FUTURE SUPPLY

Over the next three months, the majority of respondents expect demand to either rise or remain constant. This is because:

*'There is some pent-up demand out there now...'* – Group A

And *'because people are spending less, which means businesses will need money in the short run.'* – Big Four + 2

While those anticipating no change in demand do so because they

*'Need to wait until 2010 to see any change in demand'* – Group A

Or because they *'expect little change over next 3 months – extra red tape tying up directors' time dealing with things such as the detailed enforcement of filing deadlines by Companies House, is something which was not done in the past. It takes the directors' focus away from refinancing issues.'* – Anonymous

The main demand is for more working capital. Demand for funding for most other reasons (capital investment, mergers & acquisitions, investment in commercial property) is very much reduced, although a minority are seeing some balance sheet restructuring.

However, moving forward there is a relatively positive outlook on the supply of financing for SMEs with most respondents expecting it to either increase over the next three months, or stay the same over the next three to twelve months but increase thereafter.

> *'Indications are that supply will start to improve over the next three months. The banks are telling us that.'* – Group A

> *'No huge change over three months. Would expect that things will get significantly better – the Bank of England has injected so much and it's being hoarded. Sooner or later the banks won't want to sit on it. There's enough money going in that it will start leaking out – by the banks lending more. There won't be a return to the levels of 3 years ago, but the banks will be back to a steady growth in a year, assuming no more catastrophe(s) bringing down the system.'* – APA

> *'Supply will increase because there will be more pressure on banks that are taking public money and that will hopefully bear more fruit. And as the banks continue to get to grips with what they've got in their loan portfolio, that will allow them to start lending again.'* – Big Four + 2

> *'Supply will increase because banks need to earn profits. They have already cherry-picked profit sources so will have to broadly increase.'* – Anonymous.

## SINGLE POLICY INITIATIVE SMES PARTNERS WOULD MOST LIKE TO SEE THE GOVERNMENT TAKING TO HELP SMES

The two leading requests (each from a minority of respondents though) are to reduce taxes on SMEs (including VAT and employers national insurance) and to force the banks to lend more by some means.

> *'The single policy initiative for the Government should be on reducing employment taxes which are becoming prohibitively expensive – the increases in NI contributions is another step too far.'* – Group A

> *'The government needs to understand how the banks are working at ground level with SMEs. Somehow they have got (to get) the banks to demonstrate that they are lending, but I don't know how you force a bank to lend.'* – Group A

A small number also asked to see a reduction in red-tape and the burden of administrative tasks that SMEs have to perform to meet various regulations.

Other suggestions include:

- Revert to more flexible timing for filing at Companies House (as this takes up directors time).
- Reduce corporation tax for SMEs.
- A court of appeal where a business can dispute a bank's judgement that they are not a going concern.
- Lower VAT for certain types of business.
- Make sure such a banking crisis can never happen again.
- Something that would allow auditors to get a bit more involved in financial training and assisting SMEs than they are allowed to at present.
- Improve awareness of the VAT options and other areas (such as business rates, where there is actually a fair degree of flexibility), pulling all this information into one easily accesible source.

# BANK AUDIT PARTNERS

Three additional interviews were conducted with partners of firms who audit banks, in order to highlight some of the issues banks face when lending to the SME sector. All were from 'Big Four + 2' firms and have a combined experience of over 60 years. However, as this sample only constitute three individuals, the findings should be treated with due caution. For the purposes of this report, they will be referred to as 'Bank Audit Partners'.

## SUMMARY

While respondents consider that banks are now more cautious, and keen on security, they are still willing to lend, partly because this affords them the opportunity for higher margins. All recognised the conflicting pressures to which banks are subjected.

There was agreement that SMEs attract higher risk-weighted capital requirements, and that the way banks deal with breaches in lending conditions have not changed in any substantive ways since the Lehman collapse, including changing repayment terms. Although this group took no view on whether the cost of finance is currently too high or too low, they do note – as do the SME partners – that banks are increasingly linking funding to LIBOR. There is no consensus, however, on the likely timing of economic recovery, including demand for finance, or on whether banks would change their lending criteria.

In terms of government support, views of audit partners are in line with those of SME partners – support should not be sector-specific, but depend on the business case under consideration. Government lending schemes are felt to be too complex, and not apparently working effectively. Further, bank audit partners endorsed the plea from SME partners for a reduction in the red tape to which SMEs are believed to be unnecessarily subject.

## SME FINANCING

The primary view is that there has been little change in bank financing of SMEs, although there is recognition of increased caution on the part of the banks, particularly with regard to new lending:

> *'There's a lot of hot air talked about this, but banks are still interested in good business'*

This view is not dependent on sector or size of the SMEs, though one respondent pointed out that smaller companies are riskier. Little was known about whether this differed by bank, but one suggested that *'stable banks can act faster'.*

There was general agreement that security-backed lending was preferred, and one felt that three to five year loans and mezzanine finance were less available. There was also consensus that bank margins were higher, offset to some extent by reduced interest rates. One felt that the recession had had a positive impact, in that it *'is causing banks to get closer to their client base – which is good – there are now fewer transactional deals and more work based on the relationship model'.*

There was agreement, too, that the banks are under political pressure, although this view was not often reflected in interviews with SME partners:

> *'RBS is between a rock and a hard place'*
>
> *'Banks without government funding resent paying for the excesses of others'*
>
> *'Immense pressures'*

Regulatory requirements such as Basel 2 were felt by some to constitute a disincentive to providing funding, because of the 'stress test' approach, which will continue to restrain banks. However, one felt that Basel 2 had become irrelevant, as all banks have to carry much more capital now anyway, which was what Basel 2 sought to do, i.e. *'the main problem that needs fixing is to build capital in the good times and to be able to release it as you go into the bad times'.*

Respondents were unanimous that SMEs attract higher risk-weighted capital requirements (*'but they always have'*). But these were felt to have increased for all sizes of business, not just SMEs, and not varying much by sector. So the feeling was that these requirements had increased in absolute terms if not necessarily relative terms.

There appears to be both lack of knowledge and some confused thinking on the issues of demand and supply, with these two issues being inextricably linked. The prevailing view is that some supply is still available, but *'it's a challenge for banks to find enough companies who want to be lent to'.*

Yet, the withdrawal of foreign banks has had some impact on the SME market, and

> *'The cost of lending has risen, which has reduced demand'.*

> *'Business investment is harder to justify and a lot of investment projects are no longer viable'.*

In terms of types of funding, one respondent felt that overdraft facilities were 'exhausted', another pointed to a swing towards equity and away from risk, while the third believed there had been no change. There are similarly different views of expected demand in the next three months, with one foreseeing no change before Q4, another an increase (*'but not for any clear reason'*), and the third a decrease 'because the slowdown is still working its way through' although this would be combined with an increase in demand for longer term fixed loans. So, the differences are essentially those of timing – particularly timing of the nadir in the economy.

On the supply side, some sectors are expected to be affected more than others, with the most acute decline in commercial property, car dealerships and leisure companies. But,

> *'You may be OK if you are a company that produces infrastructure, as this is government-funded'.*

There is some expectation of supply increasing – if only marginally – over the next three months, but one respondent felt even this to be unlikely:

> *'Not rising because of capital constraints'.*

Again, there was no consensus on change in criteria used by banks when assessing SMEs:

> *'Because likelihood of default has risen, the hurdle to get extra credit is higher'*

> *'Absolutely, much tighter in all respects'*

> *'Not much change from what they have always looked for – a secure source of cash flow to meet interest payments and ultimately repay the principal – at the end of the day a banker looks at the cash flow'*

Two offered views on secured lending:

> *'Appetite for higher loan-to-values is lower and will stay low for a while. For loan-to-income I suspect we're coming back into a 3 to 3.5 times world…'*

> *'The value of security, has fallen. Banks are demanding a bigger hair-cut'*

## RELATIONSHIPS BETWEEN SMES AND BANKS

There was broad agreement that the way banks dealt with breaches in lending conditions had not changed in any substantive way:

> *'They are pragmatic – 'let's work this out together'*

> *'SMEs complain more because they have more personal commitment to their business. The big issue with SMEs is losing control of their business; if it is salvageable then surgery is forced on them… Also, the value of SMEs' security has fallen, so they can fall into a technical breach and the banks charge them more.'*

> *'Most banks follow a consistent process. If there has been a major breach then they transfer it over to some sort of intensive care operation… I do think the banks are being quite patient… the banks' appetite for foreclosing and closing things down is quite low'*

However, there was some mention of banks changing the repayment terms if there was a breach.

## COST OF FINANCE

Not a lot of expertise was claimed here. There seems to be a general view that *'the market must always be right'*, tinged with a sense that

> *'…it may be a bit too high now'*

*'It looks a bit high at the moment'*

*'About right, having been too low for a while. Time will tell'*

There is, however, a clear sense among bank auditors – as there is among SME partners – that banks are pushing towards LIBOR-based funding whenever they can. In terms of charges for unused facilities, one respondent sensed that

*'Banks are keen to withdraw unusual facilities'.*

## GOVERNMENT SUPPORT

Views expressed here broadly mirror those of the SME partners. The government should support any type of business which can demonstrate it has a good business model, regardless of sector, but that it should steer clear of trying to improve their 'financial management' skills:

*'Not the role of government. Banks can help with best practice, etc'.*

One respondent felt that SMEs can – and should – do a lot more in the way they present their affairs to banks:

*'It helps if SMEs can demonstrate reliable ability to forecast cash flow'.*

And SMEs – led by entrepreneur-types – are less good at this than larger companies. These bank audit partners believe that it is perfectly feasible for lenders to assess whether a business is 'viable' for purposes of lending money to, but

*'Not sure how appropriate this assessment is for recommending government support… the businesses that are in good enough shape to meet banks' lending criteria probably don't need government support. The ones that need it probably fall short of the banks' assessment criteria'*

There was criticism of the practicality of accessing government schemes, on grounds of complexity:

*'People give up when they start to read the small print'*

*'Too many schemes – it's confusing'*

Little is known about the two specific schemes asked about – EFG and Working Capital – but one respondent commented that *'neither scheme seems to be delivering'*.

## FINAL POINTS

There is some scepticism, also seen by SME partners, that what banks do and say may not always be the same, with a lot of public statements, but a limit to the amount of risk they will take:

*'The reality is banks are talking a slightly better game than is being delivered in practice'*

*'Don't know from observation but common sense suggests banks tell SMEs to come and get loans, but then put up objections/barriers when they do'*

*'Bank attitudes have changed quite quickly, and they take longer making decisions'*

One respondent had an additional point to make about bank funding:

*'My colleagues on the business recovery side are working hard with banks to ensure businesses do survive'*

Finally, the bank auditors had these points to make about government policies, some reiterating the themes of clarity and red tape reduction articulated by SME partners:

*'Provide clarity to the SME audience on various initiatives that have been announced, and make them easy to apply for'*

*'Get the Government schemes that are already out there to work properly before announcing any new schemes'.*

*'Make life simpler for SMEs. Less form-filling. Mandelson's not going to like the answer – it's to make their life simple. Take away a bunch of the regulatory burden. I don't mean FSA type – take away some of the compliance requirements. Make their tax returns and related burdens more straightforward. Give them a bit of a break in business rates'.*

# APPENDIX

## TECHNICAL DETAILS

The ICAEW contacted accounting firms from the Big Four + 2 firms (BDO, Deloittes, Ernst & Young, Grant Thornton, KPMG, PwC), Group A firms (including PKF), APA firms (plus some small boutique firms). These firms were then asked to nominate three to five partners who met the criteria and were willing to participate. Their roles range from partner to restructuring partner, but all respondents were screened to ensure they dealt with UK SMEs (defined as businesses having fewer than 250 employees) across a variety of sectors and regions on a regular basis.

Interviewing was conducted by telephone between 18 May 2009 and 18 June 2009.

For the purposes of anonymity, all individual responses are held in strictest confidence and are not available to the ICAEW or BERR on an attributed basis.

## ABOUT US

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## AKCNOWLEDGEMENTS

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## PARTICIPATING FIRMS

We would like to thank the following firms* for their participation in this valuable research:

| | | |
|---|---|---|
| BDO Stoy Hayward LLP | Duncan & Toplis | KPMG LLP (UK) |
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We would also like to thank two other firms which participated in the research but prefer to remain anonymous.

*Respondents have given permission for their firm to be identified as a participant



**The Institute of Chartered Accountants in England and Wales**
Chartered Accountants' Hall PO Box 433
Moorgate Place London EC2P 2BJ UK

**www.icaew.com**