how smes can harness success

What are the growth opportunities for SMEs in the post GFC world?

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For many companies in the small and medium-sized enterprise (SME) sector, the post-global financial crisis (GFC) era has delivered a strong sense of optimism about the short to medium-term future for their business. How can this optimism be harnessed to deliver greater success and growth for SMEs? What strategies should SMEs focus on as they look ahead to FY2012?

CASH VS DEBT: THE FOUNDATIONS OF GROWTH

Recent studies indicate that SMEs are forecasting significant growth, underpinned by profitable operations, strong balance sheets, a positive economic outlook and more manageable debt. This has seen SMEs’ debt ratios (borrowings as a percentage of assets) fall close to their lowest levels witnessed in the past five years (PwC’s Private Business Barometer, October 2010). Disciplined financial management is required to find the right mix between generating sufficient cash flows from operations and relying on external debt and borrowings (eg bank loans, lease arrangements, debt factoring) to fund growth and capitalise on expansion opportunities.

Understanding the inflows and outflows of your business is the first step to determining how well you are positioned to achieve your growth aspirations. Strategies to achieve this include:

> Preparation and review of monthly cash flow projections: every business owner should have a clear picture of their company’s expected cash flow, how sensitive those projections are to change, the business strategy driving those cash flows and how quickly that strategy could be altered (if needed) to arrest poorer-than-expected performance. Understanding the answers to these questions will significantly improve your company’s chances of responding positively and quickly to change. Taking stock on a regular basis to critically evaluate operating results will allow businesses to identify any excess costs or opportunities to increase efficiencies.

> Active follow-up of debtors and payment of creditors: maintaining close working relationships with customers and suppliers will help with collecting cash and fulfilling payment obligations. Ultimately, businesses should aim to align the number of days that it takes to collect cash and settle debts to ensure there is not an unexpected shortfall which has to be covered for an extended period of time (eg by relying on a bank overdraft facility).

> Maintaining a sustainable debt-to-equity ratio: the financial reporting impact of a change in borrowing terms and conditions, the cash impact of immediate debt repayment or the business impacts if previously available funding is withdrawn are essential issues for SMEs to consider. The accounting standards contain complex rules associated with debt modification and extinguishment, which may impact the underlying and reported earnings of the business and key financial reporting ratios. For example, when renegotiating the timing of the principal repayment of an existing loan arrangement, a change of 10 per cent or more in the old and new discounted cash flows will require the existing borrowing costs, most of the renegotiation costs and the extinguishment of the existing liability to be recognised immediately in the income statement.

ASSET IMPAIRMENT

Writing down assets for impairment is never good news for any business. Coming to terms with the requirements of the impairment standard is an ongoing challenge for some SMEs. To manage this and ensure that sufficient value is retained in your asset base to support growth, SMEs should remain vigilant in the following areas:

> Undertaking appropriate pre-acquisition due diligence: SMEs should ensure that a sufficiently robust and thorough review is undertaken before purchasing a business to understand the true value of the assets that would be acquired. This will enable any operating synergies and efficiencies to be identified, help owners articulate the intangible value of the assets and prevent over-capitalising in high-risk, low-return investments.

> Identifying goodwill and other intangible assets acquired in a business combination: failure to invest sufficient time and resources before the deal is agreed can affect the way that companies access future tax deductions, recover acquired assets and get the amortisation charge right in each period. Appropriately valuing acquired intangible assets is imperative to avoiding future write-downs.

> Testing the recoverability of both tangible assets (eg property, plant and equipment) and intangible assets (eg goodwill, brands and licences): SMEs should remain alert to indicators of impairment such as technical obsolescence, significant fluctuations in market interest rates or plans to restructure the organisation, which may require the carrying value of assets to be re-assessed. All companies that acquire goodwill must allocate and test it for impairment at a sufficiently low level in line with the segment reporting rules. This issue can be a sleeper for SMEs. Most find themselves outside the scope of the segment reporting standard, which means they don’t need to disclose segment
information in their accounts. However, SMEs are automatically brought into the scope of the standard where they have acquired goodwill on their balance sheet, so the standard casts a wider net than many might think.

**R&D: USE AVAILABLE INCENTIVES**

Keeping abreast of technical and regulatory changes can literally pay off for SMEs. There are a variety of government grants, industry assistance packages and tax benefits available for SMEs. One such incentive is the federal government’s research and development (R&D) tax concession, which the government proposes to replace with a R&D tax credit in an attempt to encourage more SMEs to engage in R&D activities.

The new scheme seeks to provide more generous financial support to SMEs with a group turnover of $20 million or less through the introduction of a 45 per cent refundable offset. Companies with turnover greater than $20 million will have access to a 45 per cent non-refundable offset. To qualify for the benefit, companies must engage in core or supporting R&D.

Core R&D will no longer focus on the existing criteria of innovation or high levels of technical risk. Instead, under the proposed changes, core R&D activities must be:

- **Experimental activities whose outcome cannot be known or determined in advance.** For example, there is a clear risk that the outcome of the experimental activity will not produce the desired result.

- **Determined by applying a systematic progression of problem-solving techniques based on principles of established science.** For example, testing the ability of a new chemical to reduce carbon emissions based on similar properties of an existing compound.

Supporting R&D activities are “activities directly related to core activities”. For example, these activities are outside those undertaken as part of the normal operations of the business, such as developing a computer model to assist in interpreting the results of the experiment.

Under the proposed changes, companies that are in a tax loss position (and are under the $20 million group turnover threshold) will be able to “cash out” their R&D benefit with no cap (the current R&D tax offset program is limited to $2 million in R&D spend, resulting in maximum refunds of $750,000).

Having the systems in place to capture the detailed information needed to support the R&D claim will be critical in order for SMEs to assess their entitlement and support their claims. Thinking about this now will be key, especially if the proposals are passed in their current form with a start date of 1 July 2010.

**PRIVATE EQUITY – AN ALTERNATIVE GROWTH STRATEGY**

Positive results and strong forecast growth are improving the value of businesses. This brings opportunities for ageing baby boomers who were unable to sell their business through the GFC and those looking for equity growth more generally.

The post-GFC era has seen a return of private equity players to the SME market. While the level of activity in the past 18 to 24 months has been restrained (approximately 20 per cent of pre-GFC levels), many private equity backers are now on the lookout for quality private companies to add to their portfolio of investments. This is highlighted by the fact that approximately $4 billion of funds is expected to be raised during the year to June 2011, the most since 2008. Making certain your business stands out from the crowd is all about demonstrating that your business can earn a sufficient return for potential investors.

In questioning whether the private equity option is right for you, consider the following:

> **How will your business fare in a due diligence review?** For many business owners the due diligence process can be a daunting experience. Focusing on building the financial strength of your business and being aware of what potential investors look for, including how they measure and define financial success, is an important consideration. Ensuring your business has a track record of quality financial reporting and a healthy set of books is an excellent starting point for imparting confidence to private equity players. It will also allow business owners to maintain greater control over the flow of information throughout the process.

> **Do you need to grow the skills of your finance team?** Private equity investors will typically expect high quality, accurate and detailed reports and possibly skills (such as the ability to deal with complex financing arrangements) not currently possessed by existing staff. Recognising the right time to bolster your company’s skills is critical, with many business owners aware that attracting and retaining talented staff is equally important as focusing on sales and marketing strategies.

> **Which private equity firm is right to help grow your business?** This is where it pays to do your homework. It is important to consider whether potential business partners are the right cultural fit for your business and understand how they plan to manage the day-to-day operations of the new look business.

**BEST PRACTICE FINANCIAL REPORTING**

There are now a number of choices available to SMEs when it comes to preparing their annual financial report. With the recent introduction of the reduced disclosure regime, Australia now has a three-tiered reporting system. Most SMEs are expected to report under tier 2 or tier 3 of the regime.

> **Tier 1:** requires full compliance with International Financial Reporting Standards (IFRS) for publicly accountable entities (ie entities that have listed shares on a stock exchange)

> **Tier 2:** requires full compliance with the recognition and measurement requirements in IFRS with reduced financial reporting disclosures for non-publicly accountable entities

> **Tier 3:** continues to allow special purpose financial reports to be prepared by non-reporting entities. The AASB is undertaking research to determine whether the current reporting requirements for non-reporting entities should change.

Maintaining quality and credibility on the financial reporting front is critical for SMEs. Deciding which financial reporting tier is right for your business should not purely be about the needs of your current financial statement users. For example, while the directors of a private company might find that a special purpose financial report is sufficient now, that may not be the case if, in 12 months time, the business is likely to grow through a trade sale or private equity deal. In these circumstances, moving to general-purpose financial statements early on might be the better option.

**WHERE TO FROM HERE?**

This is now a time of great opportunity for SMEs with many demonstrating they are well positioned to maximise their strategic objectives.

PwC is running a financial reporting seminar for SMEs in April 2011 to help businesses focus on their June 2011 financial reports and opportunities for growth. For event details contact paul.r.lewis@au.pwc.com or ryan.oconnor@au.pwc.com.