Brendan Murtagh, ACCA President
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Subject: The need for consolidation of SMEs

Distinguished guests, ladies and gentlemen.

I am delighted to be with you today and to take part in this important conference which looks at the need for the accountancy profession to adapt in challenging times

Our profession is under more intense scrutiny than it has been before – we face greater challenges than ever – and we are part of an ongoing debate about how businesses can be helped to recover from the global economic crisis – and how we can play a role in helping to prevent a similar crisis in future.

One of the most critical areas of any economy – and one where we will see the first signs of sustained recovery - is in the SME sector which accounts for 98% of all enterprises in any economy and provides more than half of all employment opportunities. As you know, here in the Caribbean, the SME sector employs 40-50% of the workforce outside of the public sector. In Jamaica alone, that figure stands at 80% whilst in Trinidad and Tobago there are some 80,000 SMEs responsible for 90% of all business and contributing more than 45% of GDP.

It is a sector in which ACCA has considerable interest – more than 70,000 of our members work in or for SMEs, with many of them small and medium sized practitioners and with a keen understanding of the issues which small businesses face.

The subject of my presentation is the need for consolidation of SMEs.

I think the first point to make is that consolidation for its own sake is pointless.

While it is tempting to think that economic growth and development rely on growing a corporate elite of large national champions, the fact is that as SMEs' share of employment and GDP tends to grow the wealthier a country becomes.

Moreover, the optimal size for a business is determined by the economics of the sector, the product and the market in question.

There is such a thing as "too big" and often the threshold is a lot lower than people think.

Industries as diverse as crafts and IT services, or hospitality and real estate, are not particularly suited to very large firms and can frustrate would-be empire-builders.

And a fragmented sector is usually good for competition, which in turn is good for consumers. Policymakers who are seeking to encourage consolidation should not be surprised if incumbents then start to collude in order to raise prices or worse, barriers to entry.

However, it's not too hard to make a rational case for consolidating some SMEs, in some sectors. The essential test of whether consolidation makes sense is whether the combined business will be worth more than the two existing SMEs individually.

If SMEs are going to grow they need to have sustainable financial and management structures in place – and the next stage in development requires a great deal of planning before they take that step.

In many cases the need for the next step creeps up on the small business owner.

It may arrive at the point at which they employ that one extra member of staff and realise they are they are going to need HR expertise, or the point at which they know that they can no longer fit in trying to balance the books at evenings or weekends –and they know that they need to bring in the services of a professional accountant. It could be the point at which they want marketing expertise or they need to negotiate a complex deal.

Everyone here knows that professional accountants - members of the bodies gathered here today – have a great many services which they can offer – ranging from advising on inheritance, succession planning or business transfer issues, Human Resources and employment regulations, pensions, budgeting, marketing, sales , valuations, Information Technology, regulation and, of course, on business structures.

But I am not sure that all our potential clients in the SME sector are necessarily aware that our skills go beyond preparing the books or dealing with the taxman.

And this is where I would like to raise an issue and a challenge for all our members.

In many instances, a growing and developing small business often leaves it until the last minute before they approach professional accountants for advice. In many cases they try to go it alone – seeing us as an unnecessary expense.

We believe that it is the responsibility of those providing services to the SME sector to be more proactive about the services which they provide. Rather than waiting for small businesses to call, accountants should put a structure in place which offers easy access to the advice that they can offer. There could also be a case for developing more specialist business advice which can also be offered more publicly.

Small and medium sized practitioners also need to build networks and develop strategies to extend their offerings.

This may involve the process of developing close links with other professionals, including Small Medium Practioners or lawyers in a location, so that work can be referred to the most appropriate specialists to help small businesses develop.

In some countries, there is a move to develop Multi-Disciplinary Practices – a type of one-stop shop of professional specialists - who can help SMEs prepare for the next stage of their development.

ACCA allows its members to recruit non-accountants to join practices, and in the UK there has been a recent change in legislation which allows law firms to recruit non-lawyers, on the proviso that they are subject to the rules of the legal regulator.

SMEs which are looking to consolidate will have a range of issues and questions which accountants have a critical role in helping to provide the answers.

Those solutions will not only involve helping with considerable planning, but also a degree of emotional preparedness.

This emotional side of SME growth should not be underestimated.

For accountants it is critical to be aware that when advising someone who has built a business from nothing that the next step could result in them losing a great deal of the influence they have had over their 'baby'.

As I said earlier there may be a case for consolidating some SMEs, in some sectors, provided that the consolidated business passes the acid test – which is that it is worth more than the two existing SMEs individually.

That test can be passed in the following ways.

The first is through economies of scale or scope.

This is the usual argument for consolidation, but, unlike large corporates, with SMEs it's not just about cost-cutting, efficiency, or market dominance, but simply about growth.

For instance, internationalisation or the ability to adhere to quality standards can be very costly and require a substantial investment in compliance and other resources, but SMEs with plans for substantial growth simply cannot avoid working internationally.

A case in point would be that of compliance with IFRS standards. IFRS for SMEs has been formally adopted by ICAC and several of the national Institutes which make up ICAC's membership. Whilst the adoption of these standards is meant to simplify the level of accounting and auditing requirements it would signify considerable changes to how SMEs currently operate in terms af financial reporting and are not entirely relevant to MSMEs. I know that the local bodies have done and still continue to do a lot of work to promote the standard but there is the ongoing debate about the merits and demerits for using it.

There is also the case made for consolidation leading to greater bargaining power.

Small businesses don't always get a good deal from large customers or suppliers and it might make sense to team up and achieve better terms.

For instance, two small construction firms forced to extend three or four months' worth of credit each to their large customers may not survive an economic downturn – but if they combined they could negotiate a much better arrangement.

There may be Synergies between consolidating companies.

Business assets owned by separate SMEs – especially intangibles – could be worth much more if combined.

For instance, most SMEs are unaware of, or unable to leverage, a good deal of their intangible assets – from in-house inventions and innovations to inherited customer lists.

Others are great at marketing and business development, but very poor at coming up with new products or services. If the intangible assets of one SME can be combined with another's commercialisation skills, the combined business will be worth much more than its constituent parts.

Unfortunately, the SME sector has more than its fair share of poor managers and complacent owners, and, what's more, they are often the same people!

Sometimes small business owners/managers are unable to sack staff who are close family members, or personal friends.

Other times they become obsessed with a personal idea, despite the fact that the market has handed them a death sentence.

Consolidations can increase the value of these poorly run SMEs by allowing more successful, value-driven competitors to take over.

Of course, even in these cases, things may not go according to plan – especially for small businesses.

It is said that around three quarters of all corporate mergers and acquisitions fail to deliver shareholder value – doomed by clashes over strategy, culture and control.

With smaller businesses, especially owner-managed ones, the potential for such conflicts rises exponentially. Remember, SMEs are often led by strongly invested owner-managers; they do not always have the benefit of huge HR departments to write up change management strategies, can't hire executive coaches and often can't pay their management and key staff enough to compensate for the frictions involved.

Seen from their perspective, successful consolidation is the rare exception.

This, however, is not the primary reason for the very low number of SME consolidations.

Rather it is the need for control – or independence – that usually gets in the way. Entrepreneurs in particular are rarely "team players" and, having built a business from scratch, are convinced they know best how to make it grow. Even among those who do overcome their reservations, very few small business owners are ready for consolidation.

Many small business owners would not be able to put a price on their business or perform due diligence on their prospective partners, making such deals even more rare and difficult.

Remember, in principle it can make sense for some SMEs to consolidate – but their owners and/or managers need a great deal of professional support in order to make this happen. The ones that choose to merge for the right reasons are much more likely to succeed, but even for them there are no guarantees.

In terms of guarantees, the lowest risk form of merger is the co-operative, which is common in agriculture.

Smaller businesses become the owners of a bigger organisation, but retain their small business status and identities.

The co-operative gives SMEs greater bargaining power and also enables them to enjoy the benefits of economies of scale.

In many fast developing economies, most notably Brazil and India, there is an increasing pressure for SMEs to make the move to match the consolidation activities of banks, financial institutions and industries in order to be more attractive to banks.

These countries are encouraging the consolidation or 'Cluster' approach. This is seen initially as taking the form of several entrepreneurs setting up in one location or business cluster, which could lead to possible mergers, acquisitions and amalgamations based on market needs and conditions.

Such clusters are seen to provide opportunities, including a range of effective links between businesses, and they are also viewed as enabling the more straightforward development of institutions that render cost- effective services to businesses.

The development of these clusters is also seen to help reduce the cost of transactions and encourage more effective competition and increased competitiveness which should result in fair prices. At the same time, SMEs which are part of these clusters will have access to more and better training opportunities and will benefit from increases in collective efficiencies.

However, for any form of consolidation to be successful, there also needs to be appropriate policies, including transparent investment rules, a business-friendly environment and an adequate infrastructure in place to help reposition the SME sector for consolidation.

There also needs to be considerable investment in the development of entrepreneurship to address the knowledge gaps and business needs of the promoters and managers of SMEs, through strategic collaboration between financial institutions, government, donors, international technical assistance providers and development finance institutions.

A possibly successful example of the cluster approach right here in the Caribbean is the case of Jamaica. Jamaican enterprises decided to come together to form themselves into "clusters" so that they could achieve greater competitive advantage in the local and international marketplace.

The Jamaica Business Decelopment Corporation (JBDC) had a collaborative input that came by way of a Cluster Sector Initiative, which was aimed at stimulating new and innovative ways of doing business by encouraging partnerships and collaboration among stakeholders involved in specific activities or "value chains," in which common interests are to be shared.

JBDC had a responsibility for five clusters: Jamaica Fashion and Apparel Cluster; Gift and Craft Cluster; Jamaica Wellness Cluster; Small Ruminants Cluster; and Egg Industry Cluster, which included some 384 stakeholders.

Each cluster was allocated a total of $20 million to assist with administrative and developmental activities.

Subsequently, JBDC provided **support services** which included: training in the areas of business plan writing, record keeping and marketing; hosting of technical workshops focusing on patternmaking, training and collection development; technical assistance to execute product packaging, labelling and design; the facilitation of local and international trade show/expo participation; sourcing of special equipment; and formalisation of the clusters.

The initiative resulted in the cluster companies having the ability to secure extensive product exposure in both the local and international markets; more efficient and productive operations; proper labelling and packaging of their products; procurement of high-value contracts; and new contacts being established for suppliers and buyers.

I mentioned that many countries are encouraging small businesses to consolidate to match the consolidation which is taking place in the banking sector.

This consolidation of banks is seen in many quarters as being more of a threat than an opportunity to the SME sector – with large enterprises seen as being more likely to be the major beneficiaries of the bigger lending portfolios which result from consolidation. Additionally, there are fears that regional banks which have been acquired by national or multinational operations might lend less to local borrowers because their parent banks have different preferred uses for the bank's funds.

One solution to the perceived problem is for consolidated banks to create SME financing subsidiaries and to ensure that they invest in capacity building of clients.

That said, however, there is little to support the view that consolidation of banks has had an impact on lending to SMEs.

ACCA's own research around the world has shown that ongoing banking consolidation has not had a significant negative impact on the financing of firms.

While consolidation has not had an impact, clearly the credit crisis has impacted on businesses' ability to access finance.

Everyone here knows that banks have cut lending, or have not passed on the full benefits of interest rate cuts. While consolidated businesses may be in better shape to ride out the continuing storm - they still have tough decisions to make on investment and staffing levels and on the best structure to survive and compete in the future.

It is critical that SMEs – whether in co-operatives, mergers or clusters - have the confidence to resume hiring and investing; - otherwise the global recovery could prove fragile.

Research by the Economist Intelligence Unit last year, which was commissioned by ACCA in conjunction with CGA-Canada and CPA-Australia, resulted in the three bodies calling for a continued focus on encouraging growth in the SME sector through lighter regulation, supportive policies, selected fiscal incentives and reasonable labour market flexibility.

We also called on governments to use tax incentives and workforce skills development to encourage investment and innovation. We also believe policy-makers and lenders should reduce credit uncertainty by publishing comprehensive information on business lending trends and lender requirements for business loans.

Banks too must be less formulaic in their lending approach, instead assessing risk on an individual basis with their SME clients. We believe that accountants must also be prepared to mediate between lenders and borrowers.

Given this is the first recession that many entrepreneurs will have faced – they may need to re-learn finance and reconsider how they do business and again that is a role which can be taken by our members within the region.

Clearly, businesses which are considering consolidation need a great deal of support and advice, and this is both a challenge and an opportunity for practitioners in the region and globally, and it is a challenge in which we as professional bodies have a duty to support our members. We have gone one step further to demonstrate our support for SMEs by signing MOUs with the umbrella bodies in Jamaica, Trinidad and Barbados and we will continue working with our members to support similar bodies in the Caribbean.

THANK YOU