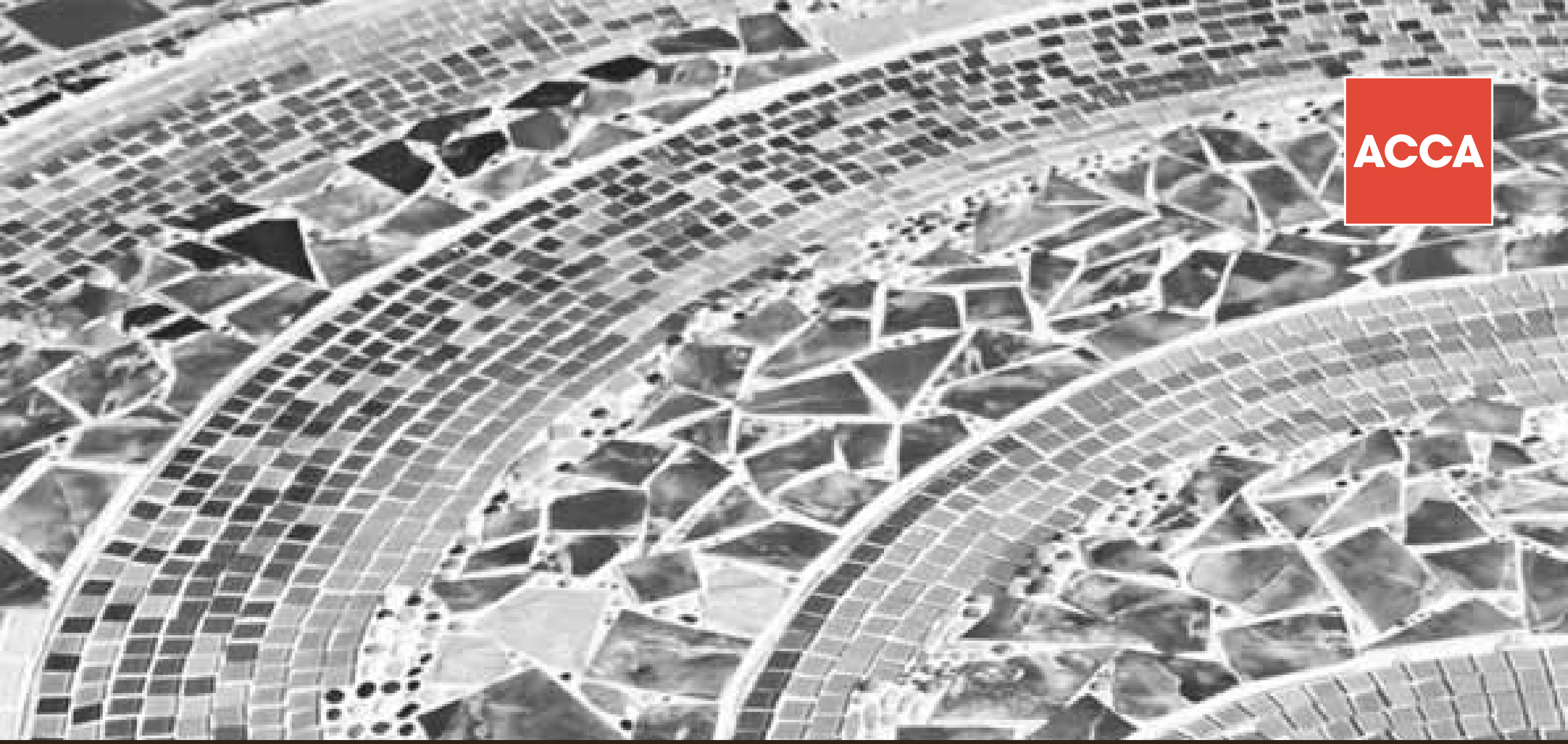
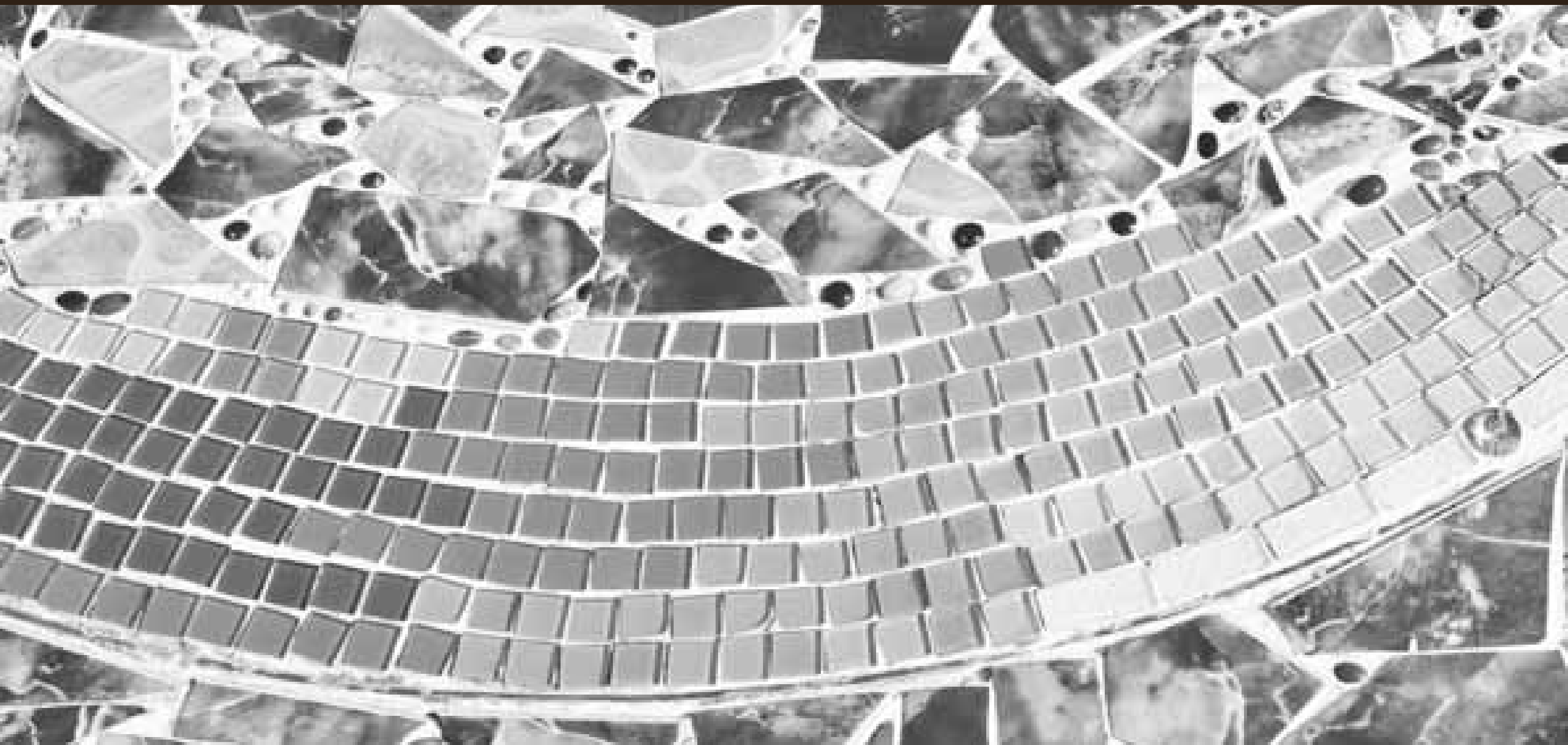


ACCOUNTANTS FOR BUSINESS

Driving SME growth through an evolving finance function



ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 147,000 members and 424,000 students throughout their careers, providing services through a network of 83 offices and centres. Our global infrastructure means that exams and support are delivered, and reputation and influence developed, at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities. Our focus is on professional values, ethics, and governance, and we deliver value-added services through our global accountancy partnerships, working closely with multinational and small entities to promote global standards and support.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest.

Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications. We champion opportunity, diversity and integrity, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting our global standards, and supporting our members wherever they work, we aim to meet the current and future needs of international business.

ABOUT ACCOUNTANTS FOR BUSINESS

ACCA's global programme, *Accountants for Business*, champions the role of finance professionals in all sectors as true value creators in organisations. Through people, process and professionalism, accountants are central to great performance. They shape business strategy through a deep understanding of financial drivers and seek opportunities for long-term success. By focusing on the critical role professional accountants play in economies at all stages of development around the world, and in diverse organisations, ACCA seeks to highlight and enhance the role the accountancy profession plays in supporting a healthy global economy.

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This paper uses data from over 10,000 interviews with UK SMEs to show how financial capability is not the result of business growth, but one of its causes.

It explores the evolution of the finance function from an informal process to a formal team or departments and highlights the critical events and concerns that drive its development. It sheds light on an often overlooked stakeholder for the profession: SMEs as employers.

FOR FURTHER INFORMATION

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Executive summary

This report uses a large sample of data from BDRC's *SME Finance Monitor*, the definitive record of UK SMEs' access to finance, to demonstrate the strong but complex link between the early development of the finance function and SME growth. It also uses insights from the international academic literature to consider the business needs that drive the formalisation and growth of the finance function, as well as the synergies that develop between business planning, management reporting, and the use of financially trained staff.

The core finding is that the development of the finance function is not the result of business growth, but one of its causes. The combination of formal business planning, regular management reporting and the use of financially trained staff is a prerequisite to a mode of rapid growth that does not jeopardise the survival and longevity of the business.

Although a significant minority of enterprises begin life with a rudimentary finance function and continue to build on this as they grow, the majority are forced to develop their finance functions on an ad hoc basis according to pressing business needs. At any given time, the bulk of the SME population is made up of very small enterprises – most of them with no members of staff other than the founder. This often gives the impression of extremely low financial capability among SMEs, but among those businesses where there is the intention to grow the reality is much more promising and fluid.

The first hint of formalisation appears pre-start-up, with the development of business plans. Only those entrepreneurs who continuously update their plans and verify them against actual performance are truly performing a finance function – and only those see any benefits from formal planning. In particular, this process gives them an edge by helping leverage their human capital.

Post-start-up, the earliest stage of finance function development addresses the need to align staff and management incentives with those of the owner(s) and set up simple financial and management controls. During this process, which is accelerated by rapid growth and/or incorporation, financial software and staff are brought into the business more or less simultaneously as a 'bundled pair'.

The second stage in finance function development addresses the need for focused growth by enabling standardisation and monitoring of business processes. During this time the finance function grows in order to enable the monitoring of cash flow and business improvements – quality management and e-commerce are two such improvements particularly associated with higher levels of finance development.

The final stage of finance function development in SMEs addresses the need for responsive growth by enabling businesses to access finance, assess the case for new products and services, monitor their supply chains and manage their headcount.

For the purposes of this research, the definition of a fully developed finance function has been particularly relaxed (formal business planning, regular management reporting and the use of financially trained staff). Yet even under this very broad definition, a fully developed finance function (involving formal planning, reporting and staffing) can be shown to contribute to the achievement of rapid growth without sacrificing the sustainability of an SME's finances. No other configuration of these three aspects of business formalisation can produce the same effect.

Finally, the findings suggest that the finance function in SMEs has a value-added role independent of statutory reporting requirements – policymakers would do well to take note of this. But we also show that financial capability is an experience 'good' and that complacent business owner/managers can overlook it under benign economic conditions. It is up to the profession to argue the case for SMEs' continuous investment in finance.

1. Introduction

A substantial part of the accountancy profession, globally, works within small and medium-sized enterprises (SMEs), yet it is often hard to engage these formally as finance employers – there are simply too many of them, and they are too diverse in their characteristics and needs.[1] Moreover, as much as it might embarrass the profession to admit it, no entrepreneur ever set out to build a top-notch finance department. Entrepreneurs set out to build successful businesses and over time they find, sometimes reluctantly but inevitably, that they need a finance function to help them get there. Somewhere along the way, the finance function develops from an afterthought to a necessity and from the proverbial shoebox to a professionally managed and led department.

This report examines a new source of data on the financial capabilities of UK SMEs as well as providing a review of the international literature in order to chart the development of in-house finance and respond to the following questions.

- How widespread is the formalisation of the finance function among SMEs?
- What stages of, or strategies for, small business growth are particularly tied to the development of the finance function?
- Does an investment in financial capabilities act as an enabler of growth and, if so, how?

[1] This report employs a standard UK SME definition (<250 employees, <£35m turnover) which is aligned with the dataset used and is broadly aligned with the EU definition.

2. Data and methodology

To help explain how finance formalisation occurs, ACCA turned to a rich source of data on SMEs in the UK: the 10,000-strong sample of the *SME Finance Monitor* as of November 2011 (BDRC 2011). The first and second wave of interviews took place from March to May 2011 and from July to September 2011 respectively.

The *Monitor*, which is funded by the UK's major banks and produced by independent researchers BDRC, is a survey of a representative, weighted sample of owners and managers of UK SMEs. It collects information about management reporting, business planning and employment of financially trained (though not necessarily qualified) staff among SMEs as well as a host of other information on business characteristics and challenges. This offers users a unique glimpse into the development of the finance function.

Three *Monitor* questions in particular were selected as proxies for the existence of a distinct internal finance function.

- Do you prepare regular management accounts?
- Do you have a formal written business plan?
- Does the person in charge of the firm's finances have any financial training or qualification?

All three questions are coded as dummy variables, so it is impossible to qualify findings or to deduce from them much more than the simple incidence of these behaviours and characteristics among businesses. Nonetheless, seen together they are still indicative of the development of the finance function and the financial capabilities of individual businesses.

In Chapter 4, we use CHAID (decision tree) analysis to group SMEs according to the most significant drivers of each of the three activities described above, and to identify sub-groups within each 'branch' of the population, on the basis of these drivers. This iterative exercise continues until there are no statistically significant distinctions left to make, or until the groups identified are too small to report on (n<50). In analysing the results, the following approach was taken.

First, the major driver of the target behaviour – the variable that defines the earliest parent branches of the tree – was identified. This was generally expected to be either turnover or employment.

For each value of the major driver, the lowest-level 'child' groups that have the highest and lowest levels of adoption respectively (referred to, for simplicity, as the 'most proactive' and 'least proactive' SMEs) were identified and their level of adoption recorded in order to define a reasonable 'range' of adoption rates.

For each value of the major driver, all other drivers of adoption flagged as significant by the CHAID methodology were listed; any patterns that emerged are discussed below.

Finally, the influences that persist throughout broad stages of business growth were reassembled and the influences incidental to a particular business size were considered, along with those that are more permanent at each broader stage of development.

A broad range of variables were introduced into the CHAID analysis in order to ensure that key variables were not acting as proxies for other, implied, factors, and that observed effects were therefore not misleading.

- Legal status of the business
- Non-profit or for-profit status
- Sector
- UK region
- Age of the business
- Age of the business owner
- Gender of the business owner
- Percentage of the business owned by women
- Reason why the business was originally founded
- Business owner/manager's experience of running a business
- Business owner/manager's academic and vocational qualifications
- Turnover (in bands)
- Employment (in bands)
- Credit balance (in bands)
- Use of external finance
- Business' growth prospects
- High-growth business status (30% per year turnover growth or more over the last three years).

3. The state of play

Across the entire UK business population, the largest share of businesses (40%) have neither of the three elements of financial capability considered in this research. The next two most common levels of competency all involve an element of management reporting, either on its own (16%) or combined with formal business planning (12%). Only a relatively small minority of businesses (7%) demonstrate all three elements.

Once business size is taken into account, however, the pattern changes rapidly; it is businesses that employ only the owner and other micro-enterprises that account for nearly all the lack of financial capability among SMEs. The BDRC sample contains no businesses with more than 50 members of staff that do not have at least one of the three levels of financial capability. Similarly, there are no businesses with more than 50 members of staff that employ financially trained staff or formal business plans without combining these with at least one other element of financial capability. Similarly, above the 200-employee threshold,[2] no businesses are left without all three elements in place.

These findings suggest that there is a link between financial capability and growth, and that growing businesses benefit from synergies between different types of formalisation. Even so, the direction of causality is unclear and the *Monitor* sample offers only a snapshot; it cannot follow individual businesses across time. To understand the dynamics involved, additional dimensions of business development must be considered in order to group businesses under distinct and coherent growth narratives. The CHAID (decision tree) analysis discussed in Section 2 provides a means of doing this.

Table 3.1: Financial capability by employment size-band

	Number of persons employed						
Level of financial capability (by strength of association with business size)	**All SMEs**	**0**	**1–9**	**10–49**	**50–99**	**100–199**	**200–49**
Business plans, management reporting & financially trained staff	7%	4%	12%	30%	50%	67%	100%
Management reporting and financially trained staff only	5%	4%	9%	15%	19%	17%	
Business planning and financially trained staff only	3%	3%	3%	2%	6%		
Business planning and management reporting only	12%	10%	18%	21%	13%	17%	
Management reporting only	16%	15%	19%	16%	13%		
Financially trained staff only	7%	7%	7%	4%			
Business planning only	9%	10%	8%	4%			
No planning, management reporting or financial staff	40%	46%	25%	8%			

Source: BDRC (2011)

[2] Despite what may appear as a severely limited selection, this is still a sample of 133 businesses.

4. Three stages in the development of finance function

Using CHAID (decision tree) analysis according to the methodology discussed in Section 2 makes it possible to visualise the development of the finance function through different business sizes and to discuss the forces that drive this. As a rule, it is the least proactive firms that drive the level of adoption of management reporting and business planning practices in the general population. About 73% of the more proactive group produce accounts even at turnover levels of less than £75m. Similarly, more than half produce written business plans even if they have no employees yet. The conclusion is that, while a minority of SMEs begin life with at least the beginnings of an adequate finance function, the majority is forced to develop one owing to the demands of simply doing business.

The Monitor data tell us that, for the average business, the development of the finance function proceeds through three distinct stages. Although we use turnover and employment thresholds to define these, the three stages are mostly not about size, but about changing business needs. Moreover, although it is not possible to reconcile all the findings to simple patterns, they can nonetheless be summarised as follows.

STAGE 1: AGENCY PROBLEMS AND FINANCIAL CONTROLS.

As very small businesses begin to generate consistent revenues (typically while they still have fewer than 10 members of staff and turnover of less than £100k), owner-managers begin to reconcile themselves to the fact that they cannot control everything or everyone, or operate without giving an account of themselves to third parties.

The earliest uses of management reporting, formal business plans and financially trained staff are therefore mostly about monitoring employees and aligning their incentives with business objectives, putting internal controls into place and, in the case of newly incorporated businesses, living up to the obligations of a company to its stakeholders. These priorities become even more pressing if the business is growing particularly fast, in which case both the use of financially trained staff and formal business planning are even likelier.

These findings are corroborated by other studies, most notably Davila and Foster (2005), who demonstrate that agency costs are an important driver in the adoption of management accounting practices in early start-ups and that the latter is positively correlated to firm performance at this stage. Importantly, they also note that professional financial managers are hired by start-ups along with the adoption of management accounting practices as a 'bundled pair'.

While many entrepreneurs pre-start-up, as well as micro-enterprises, use business plans primarily in order to approach providers of finance (Davidsson and Honig 2010), the findings discussed below suggest that the effect of external financing on the use of business planning is negligible after the effects of fast growth are taken into account. Indeed, it appears to be the case that among very small businesses, only those with aspirations of substantial growth take a consistent approach to business planning.

This is not surprising. The presence of a business plan can be a mere formality, or simply a means for finance providers to discourage the least creditworthy or investment-ready applicants; as such it does not in itself confer any advantage to start-ups – it is the process of continuous planning and revision of business plans that makes a difference to the prospects of growing firms. Davidsson and Honig (2010), for instance, find that subsequent revisions of business plans are positively correlated with the profitability of new ventures, while formulation of business plans in itself (ie the use of one-off business plans) is actually negatively correlated with profitability. Similarly, in a representative US study, Kirsch et al. (2009) find that venture capitalists gain little information from the one-off business plans used in funding applications.

> ‘the business planning process never ends.... I have been talking about going back to your plan at least once a month.... The only way to do that is to do your bookkeeping or accounting. By doing that you will be able to compare your predicted numbers in your cash-flow with the actual number your business has generated.... You will be surprised how creative you can be, once you know about and understand a problem in your business plan.’
>
> STEFAN TOPFER, CEO AND CHAIRMAN, WINWEB

Oe and Mitsuhashi (2012) offer a particularly useful insight into the role of accounting information in start-up growth. Their findings suggest that a commitment to information distribution and interpretation makes it easier for founders to put their human capital (namely their prior industry and start-up experience) to good use and thus help start-ups reach break-even sooner. It is very likely that accounting provides an avenue for such distribution and interpretation of firm information: serial entrepreneurs and industry specialists tend to know what information they would ideally need in order to monitor their businesses and therefore adequate information systems make it easier for them to exploit the advantage of their superior experience.

STAGE 2: STANDARDISATION AND MONITORING.

At the next level (turnover from about £100k to £1m, no more than 50 members of staff), small businesses with diversified internal resources begin to use financial information to optimise their internal processes. Moreover, they gradually become better at producing standardised information and feeding this into formal business plans. At this stage, quality management and online revenue become important drivers of both management reporting and business planning. In addition to this, financially trained staff are hired to monitor cash flow and manage credit as well as report on the progress and resource implications of improving business processes.

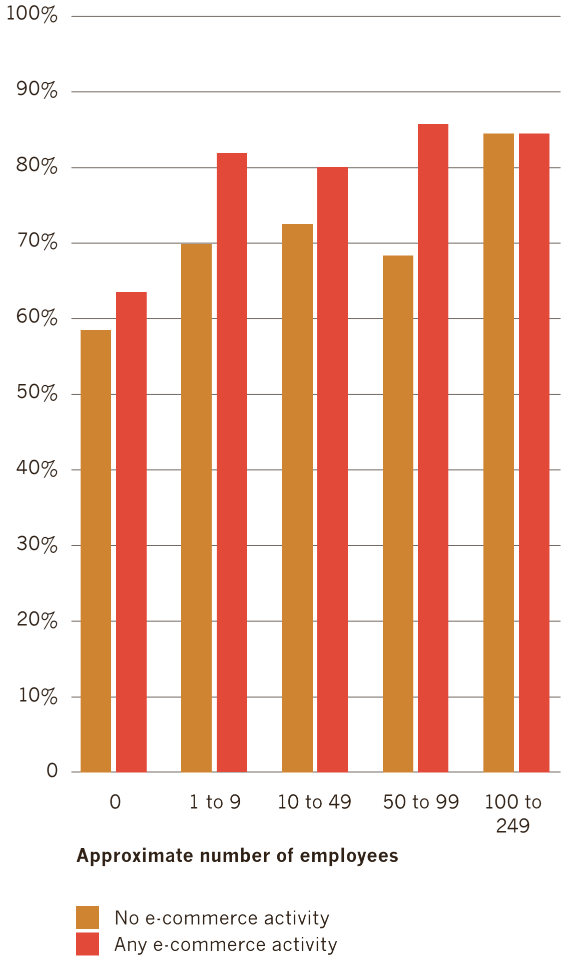
In their award-winning paper, Davila et al. (2011) demonstrate that this transition to formal monitoring and standardisation of processes is a catalyst for growth, and they even demonstrate a link between equity finance, the imposition of such controls by the new shareholders, and rapid growth. Von Krogh and Cusumano (2001) identify this as an element of what they call the ‘scaling’ strategy for growth, in which firms invest aggressively so that they can distribute a stable, focused set of goods and services widely at low cost.

> ‘We had management by personality, and it became evident that that wouldn’t scale. We figure our personalities can go through one floor and two walls. After that, management by personality doesn’t work anymore.’
>
> SME MANAGER, REPORTED IN DAVILA ET AL. (2010)

It's less clear why online activity coincides with a strengthening of the finance functions of small businesses at this stage of their development, but research (eg Phillips and Halliday 2008) suggests that important synergies exist between accounting and marketing in e-commerce. E-commerce means that small businesses increasingly rely on intangible assets such as intellectual property and user networks; it also makes it cheaper and quicker to generate information about the business, while going virtual and addressing a global audience means it's that much more challenging to allocate and control costs or to understand what drives sales. The convergence of technological and strategic decisions in e-commerce, moreover, has implications for management accounting (Bhimani 2006). The very role of the management accounting function is changing with the increased ubiquity of e-commerce, reorienting itself away from standardised information and towards more flexible reporting that enables creative managerial responses to a rapidly changing environment, both within and outside the firm (Bhimani 2003).

Some additional corroboration across countries is provided by Forbes Insights (2010), which demonstrates that businesses engaged in any kind of e-commerce activity are more likely to use accountants for advice than those not engaged in e-commerce – as predicted by our model, the difference is greatest among SMEs with between 50 to 99 members of staff but declines to almost nothing among larger businesses.

Figure 4.1: Use of accountants' advice among businesses by headcount and presence of e-commerce activity



Source: Forbes Insights (2010)

STAGE 3: ACCOUNTING FOR GROWTH.

Upon reaching turnover of roughly £1m, or 50 members of staff, a growing business may still appear relatively small to casual readers of the financial press or to government officials, but internally its resources are stretched to the limit. At this stage, management reporting, business planning and the use of trained finance staff are typically tied to supporting growth by enabling businesses to access finance, make and assess the case for new products and services, monitor their supply chains and manage their headcount. This stage corresponds more closely to what Van Krogh and Casumano (2001) call the granulation strategy for growth, in which businesses attempt to balance the need for standardisation with that for greater responsiveness to market conditions and customer needs.

Not all growth is the same, of course: the Monitor data suggest that the steady-state growth of mature enterprises of this size tends to generate more business planning than the explosive growth of what are commonly known as 'gazelles' – perhaps because this allows for periods of consolidation and reflection, or perhaps because businesses become more introverted as they begin to exhaust their potential for growth in a given market.

And then there is another kind of growth altogether: the rising tide that lifts all boats. In an economic boom, businesses can grow substantially for a while without building the crucial foundation of a finance function focused on growth. For instance, medium-sized UK businesses launched in the boom years between 2002 and 2007 were less likely, even four years later, to have a financially trained person in charge of their finances. It is likely that the need for such staff appears less urgent while economies and individual businesses are growing strongly and the firm's continued survival and growth seem certain.

Alternatively, SMEs in countries with strong financial industries, such as the UK, may find good finance staff to be too expensive during such times, as competition among employers inflates their expected earnings. Either way, many such businesses will have regretted their neglect of the finance function during the recent downturn. Evidence from previous research commissioned by ACCA (Forbes Insights 2010; ACCA and CBI 2010), suggests that during such times SMEs tend to develop a renewed interest in sound financial management.

> 'During the last year we've had numerous requests from SMEs for software improvements which provide more detailed management reports, and thus allow much closer control of costs and profit margins...It's a huge advantage to know which customers or products are making you money, and which aren't doing so well. That lets you know where best to concentrate your efforts.'
>
> GRANT HEWSON, GENERAL MANAGER, ACCOMPLISH LTD.

Figure 4.2: Percentage of UK SMEs preparing management accounts, by level of turnover

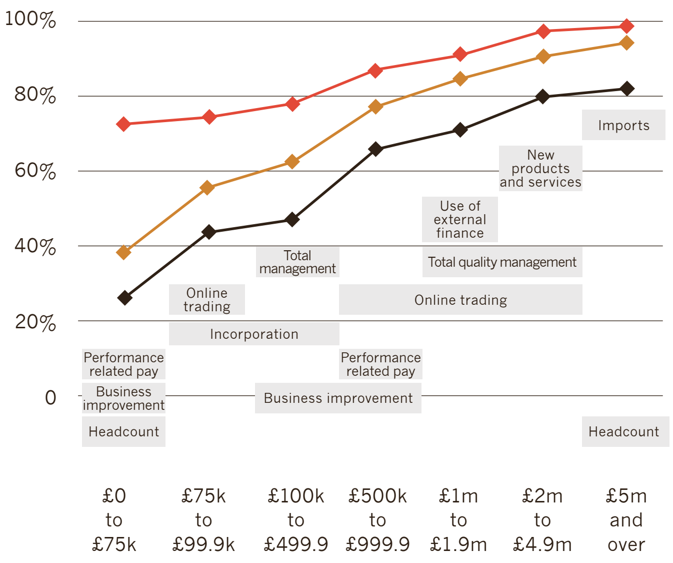


Figure 4.3: Percentage of UK SMEs preparing written business plans by level of employment

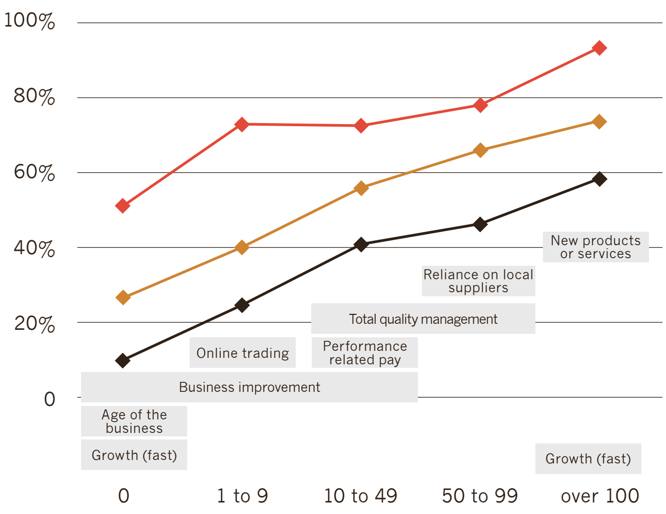
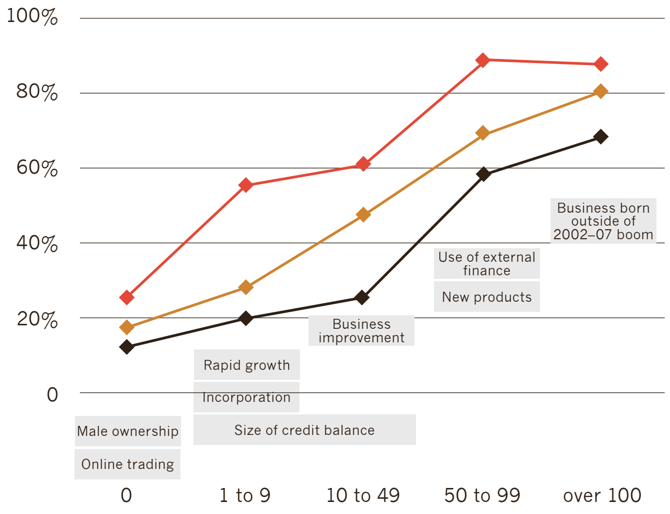


Figure 4.4: Percentage of UK SMEs employing financially trained staff by level of employment



🟥 Most proactive group

🟧 Average

⬛ Least proactive group

Note: the labels appearing under the adoption rates in these graphs indicate which factors determine whether a business will be classified as 'proactive'. A business missing all of these characteristics is most likely to be in the 'least proactive' group'.

SMES' FINANCIAL CAPABILITY AND SUSTAINABLE GROWTH

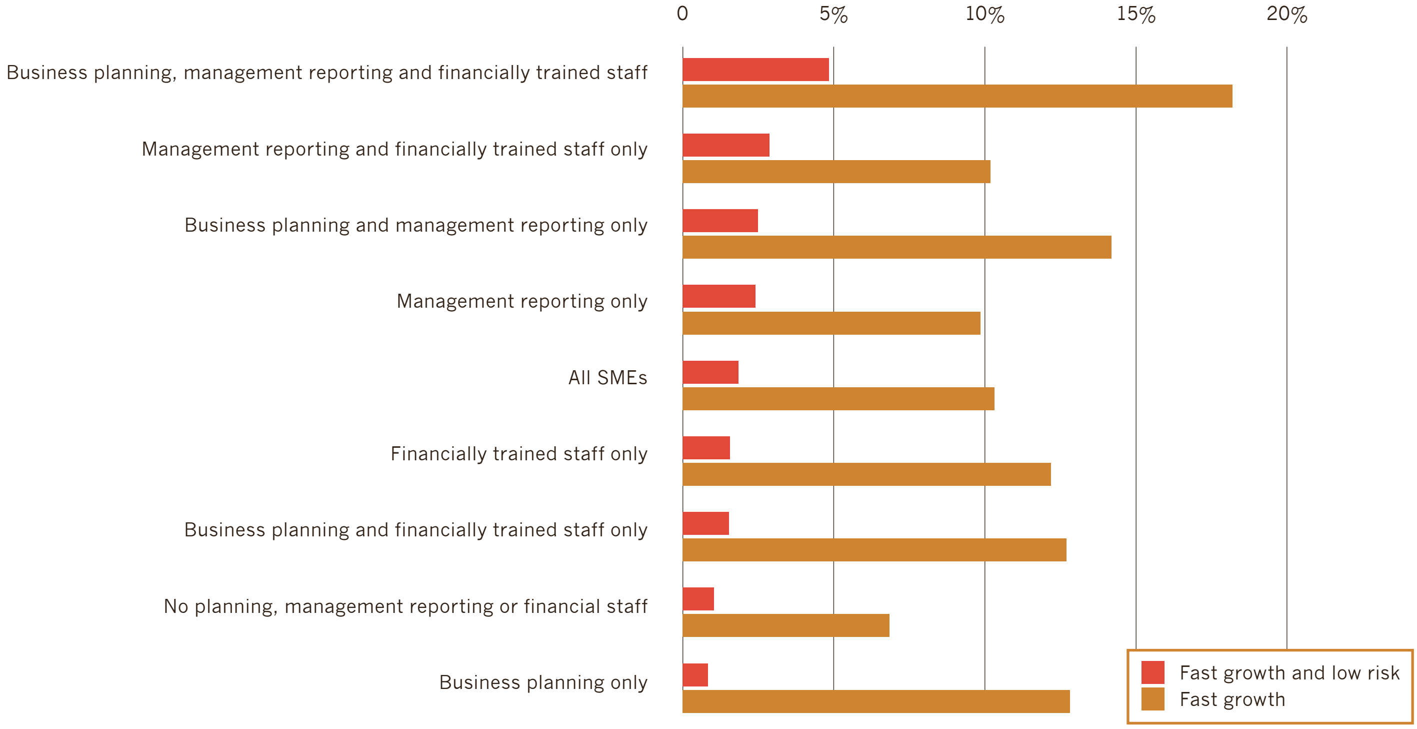
The literature reviewed in previous chapters suggests that financial management is not simply a product of the growth of firms; instead, it is often its precedent. In order to visualise this relationship in a simple way, it is useful to compare the growth rates of enterprises with different types and levels of financial capability. The *SME Finance Monitor* does not record actual growth rates, but it does distinguish between firms whose turnover has grown by 30% a year for the last three years (classified as fast-growth firms) and firms that have either not grown or grown less impressively.

Growth, however, is not always sustainable and important stakeholders such as investors and lenders know this: BDRC (2011) finds that 46% of high-growth enterprises have above-average credit risk ratings, against 42% of enterprises that haven't been experiencing high growth. It is therefore important to compare not only the growth record of businesses with different levels of financial capability, but also their ability to sustain both high growth *and* a low or minimal level of credit risk – a proxy for sustainable growth.

This analysis suggests that SMEs that engage in regular business planning are more likely to achieve high turnover growth, whereas among those fast-growing businesses, regular management reporting is associated with a low risk rating. Those with the highest level of financial function development are also the most likely to report both rapid growth and its more sustainable variant.

Of course, these simple descriptive statistics do not take into account other factors associated with growth and risk ratings, such as sector, size (measured by both turnover and employment), and start-up status. After controlling for these three in a binomial regression analysis, only the combination of *all three* forms of financial capability emerges as a mildly significant contributor to sustainable growth (p<.076).

Figure 5.1: Percentage of SMEs achieving rapid growth, by level of financial capacity



Conclusions and recommendations

The evidence reviewed in this report demonstrates the strong but complex link between the early development of the finance function and SME growth. The report also considers the business needs that drive the formalisation and growth of the finance function as well as the synergies that develop between business planning, management reporting, and the use of financially trained staff. Its findings provide useful guidance for entrepreneurs and business owners, policymakers, researchers and, of course, the accountancy profession.

ENTREPRENEURS

The main implication for entrepreneurs is that business planning, management reporting and the employment of financial staff must not be pursued in isolation from each other. The combination of the three at the earliest opportunity is an important contributor to sustainable and rapid growth.

Entrepreneurs with plans to grow must nurture and formalise these resources in advance, and be mindful of the aspects of growth that finance is best placed to support. These are:

- dealing with agency problems
- rapid growth and incorporation; standardisation and monitoring of business processes
- monitoring cash flow and business improvements (especially quality management and e-commerce)
- accessing finance
- assessing the case for new products and services
- monitoring supply chains, and
- managing headcount.

Despite this, the evidence also suggests that complacent businesses are likely to under-invest in the finance function under benign economic conditions; its services to the rest of the business are an experience good that must be put to the test before its actual value is revealed. Therefore as with most experience goods, demand can often be lower than optimal levels and entrepreneurs must be willing to consider their needs in terms of financial competency under an adverse scenario.

POLICYMAKERS

Our findings suggest that the greatest increases in the frequency of management reporting and use of financially trained staff do not occur at stages in the development of SMEs during which incorporation or other regulatory concerns are dominant influences on the finance function. Rather, during these stages the practices of the average business diverge sharply from those of its least proactive peers. The implication is that the work of the finance function is value-added and that in-house finance functions would not be substantially smaller or less developed in the absence of external reporting requirements.

Policymakers in the UK and elsewhere need to reconsider their approach to encouraging SMEs to become better managed and more creditworthy. The former, and to some extent the latter as well, may not be dependent simply on owner-manager knowledge and attitudes, as is often the assumption, but on actual resources and their combinations. Moreover, while it is easy to assume a link between finance function development and the need for external financing, this is not evident among any but the largest SMEs.

Among small businesses, the link between positive cash flow and finance function development is much more direct; presumably, external financing is typically handled by the owner-managers themselves for a great deal of an SME’s lifetime, while the finance function is for the most part charged with ensuring an adequate supply of trade finance. This can explain the finding, reported in ACCA and CBI (2010), that *external* accountants working with SMEs had much less involvement with credit policies and credit management than might be expected from their general involvement in the client’s business.

ACADEMICS AND THE ACCOUNTANCY PROFESSION

While this evidence is based on a very robust sample of SMEs from the *SME Finance Monitor*, the definitive record of SMEs' access to finance in the UK, and although the findings reviewed here echo those of the academic literature internationally, the sample employed does present a limitation. Without further corroboration through international research, it cannot be assumed that the relationships discussed here hold across countries, although they are almost certainly representative of the situation in the UK.

Finally, the link between e-commerce and the finance function merits additional research. While there is evidence that e-commerce tends to emphasise and alter the management accounting function, this has so far focused on dotcoms or large corporates – a direct link among the general population of UK SMEs was not expected. And while the accountancy profession has supported the rise of e-commerce among SMEs (eg ACCA 2011), it has not to date treated it as an opportunity for generating additional demand for accountants' services.

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