ACCOUNTANTS FOR BUSINESS

SMEs and foreign exchange risk: are small and medium-sized accountancy practices up to speed?

This report has been produced by ACCA in association with Kantox Peer FX

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.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 162,000 members and 426,000 students in 170 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 89 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

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 report explores the role of accountancy practitioners in managing the foreign exchange exposures of SME clients, and what the accountancy profession could do to improve its offering to small businesses.

It reports the findings of a survey of SMPs developed by ACCA and the Edinburgh Group, along with insights from Kantox Peer FX.

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1. Introduction

Internationalised and innovative businesses are faster growing, more profitable and better able to create wealth and jobs than their domestically focused peers (Love and Roper 2013). In working with overseas suppliers, customers, creditors and other partners, these businesses often need to deal in foreign currencies, and they expose themselves to some measure of risk in the process.

A recent ACCA-produced report, *Hedging FX Risk – Taking Stock of the Challenge for Mid-caps and SMEs* (Kantox 2013), demonstrated that small and medium-sized enterprises (SMEs) with international activities are significantly exposed to foreign exchange (FX) risk – typically around 19% of revenue – of which only a part is hedged and even less is managed in an active manner. Frustrated by complexity and cost, and with only limited resources and access to relevant skills, some SMEs may be resorting to overly expensive hedging methods or taking their chances without hedging.

Past ACCA research has demonstrated that accountants are the financial advisers of choice for SMEs (Schizas et al. 2012), and that business owners and managers almost universally regard them as experts in financial management. If smaller businesses are at a disadvantage when dealing with foreign currency exposures, it makes sense to consider how their preferred advisers can help them.

This report delves deeper into the findings of a recent survey of SMPs developed by ACCA and the Edinburgh Group, as well as additional ACCA economic research. Its purpose is to discuss the role of practitioners in managing the FX exposures of SME clients, and what the profession could do to improve its offering to small businesses.

ABOUT THE SURVEY

At the beginning of 2013, the Edinburgh Group, a coalition of 14 accountancy bodies around the world created to champion small and medium-sized enterprises (SMEs) and small and medium-sized accountancy practices (SMPs), commissioned a substantial survey among its members. The aim of the survey, designed by ACCA, was to find out more about the extent of international activity among SMPs' clients, the challenges those SMEs face in developing themselves internationally, the support available to SMEs and any further assistance governments could provide.

Fieldwork was conducted in early 2013. A total of 1,350 SMPs from over 70 countries on all continents were surveyed, with the strongest responses received from South Africa (24.1%), the UK (21.6%) and the Republic of Ireland (16.8%); and adequate samples also received from Romania 6.9%) and Turkey (4.6%). Headline findings from this research were published in June 2013 under the title, *Growing the Global Economy Through SMEs* (Edinburgh Group 2013).

Table 1.1: Sample profile

Countries	Respondents
South Africa	229
UK	206
Rep. of Ireland	160
Romania	66
Turkey	44
Rest of World	247
Continents	
Asia	69
Europe	536
Africa	281
North America	38
Latin America	2
Australasia	8
Unknown	18
Practice size/complexity	
One office	771
More than one office in one country	116
Offices in several countries	43

2. SME internationalisation and SMPs' FX services

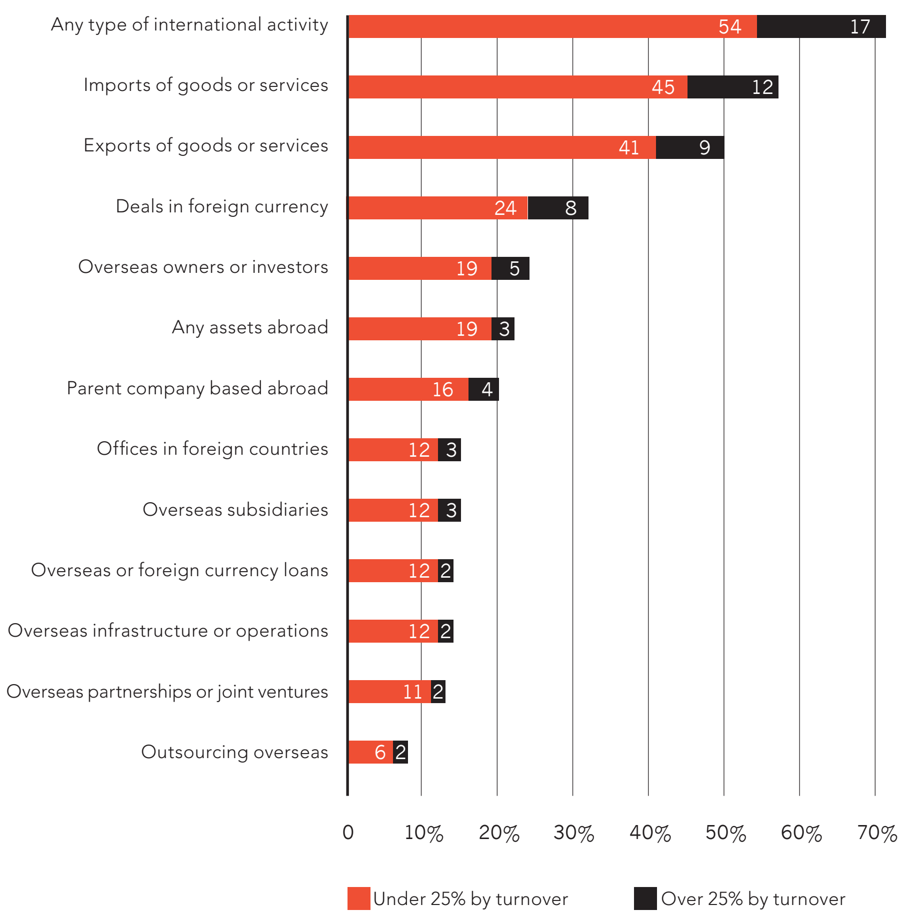
The majority (71%) of SMPs in the study had SME clients with at least some kind of international activity, and just over one in six (17%) earned more than a quarter of their practice's income from clients with international activities (Figure 2.1).

As might be expected, imports and exports are the most common types of international activity, with 50% of SMPs reporting that at least some of their clients export goods or services. That said, and in keeping with past research findings (eg EIM 2010), SMEs appear to be much more international than is often assumed. Just under one in six practices (15%) had SME clients with overseas offices or subsidiaries, 12% had SME clients with operations abroad and 13% had SME clients involved in overseas joint ventures or similar partnerships. Over one in five SMPs had clients with overseas owners or parent companies.[1]

As Figure 2.2 demonstrates, SMPs' clients also tend to be more exposed to FX in countries whose banking sectors are more integrated with those of foreign countries – as is often the case in Central and Eastern Europe.

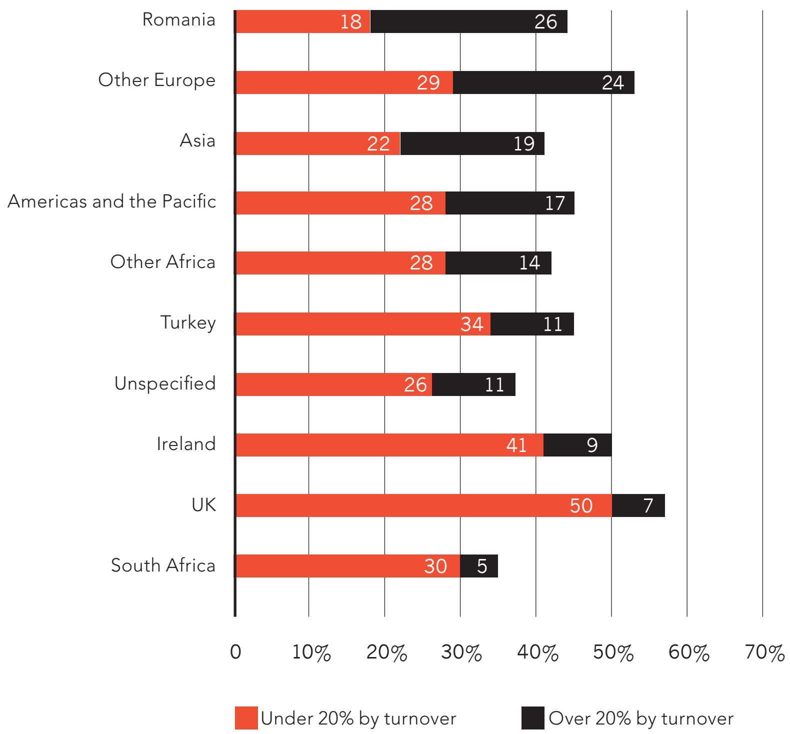
As a result, just under one-third of respondents (32.4%) had clients who dealt in foreign currencies, and about one in three of those (11.4%) claimed that clients with FX exposures made up more than 25% of their practice's income.

Figure 2.1: Percentage of SMPs who have SME clients with international activities, relationships and exposure



1. Technically, most national SME definitions apply to independent enterprises only. Subsidiaries of organisations that would be classified as large taken as a whole are not usually considered to be SMEs.

Figure 2.2: Intensity of client FX exposure by location (SMPs with internationalised clients only)



Imports are typically the first trigger of SMEs' FX exposures. Around half of all SMPs working with importers claim that they have clients who deal in foreign currencies, and FX-exposed clients' share of the practice's income increases as more of the practices' income is derived from importers.

The second trigger is an element of overseas ownership or corporate control – the strongest impact on clients' FX needs generally comes from having overseas owners or investors, parent companies, or joint ventures and partnerships, in that order. When any of these three factors occurs among an SMP's client base, two out of three such practices will also tend to report that they have clients with FX exposures. Normally, such clients are rare, and practices with multiple clients of significant size involved in such partnerships will tend to have developed some level of specialisation.

3. Is managing FX a problem for SMEs?

SMPs whose clients deal in foreign currencies tend to see this part of doing business abroad as a mid-ranking and rarely acute problem. While about 45% claim it is an issue for their SME clients, only 8.5% see it as a major issue (Figure 3.1).

By comparison, foreign regulations, skills gaps and shortages, as well as cultural barriers, are far more common complaints, and the most commonly cited acute problems are competition and finding reliable partners overseas.

The data may indicate a blind spot among SMPs. Practitioners are much more likely to regard FX as a problem if over 25% of their fee income comes from SMEs that deal in foreign currencies, or if their clients have overseas creditors or FX-denominated loans. So are SMPs who deal with clients' overseas partners and joint ventures.

Figure 3.1: Incidence and acuity of different business challenges as reported by SMPs whose clients deal in foreign currencies

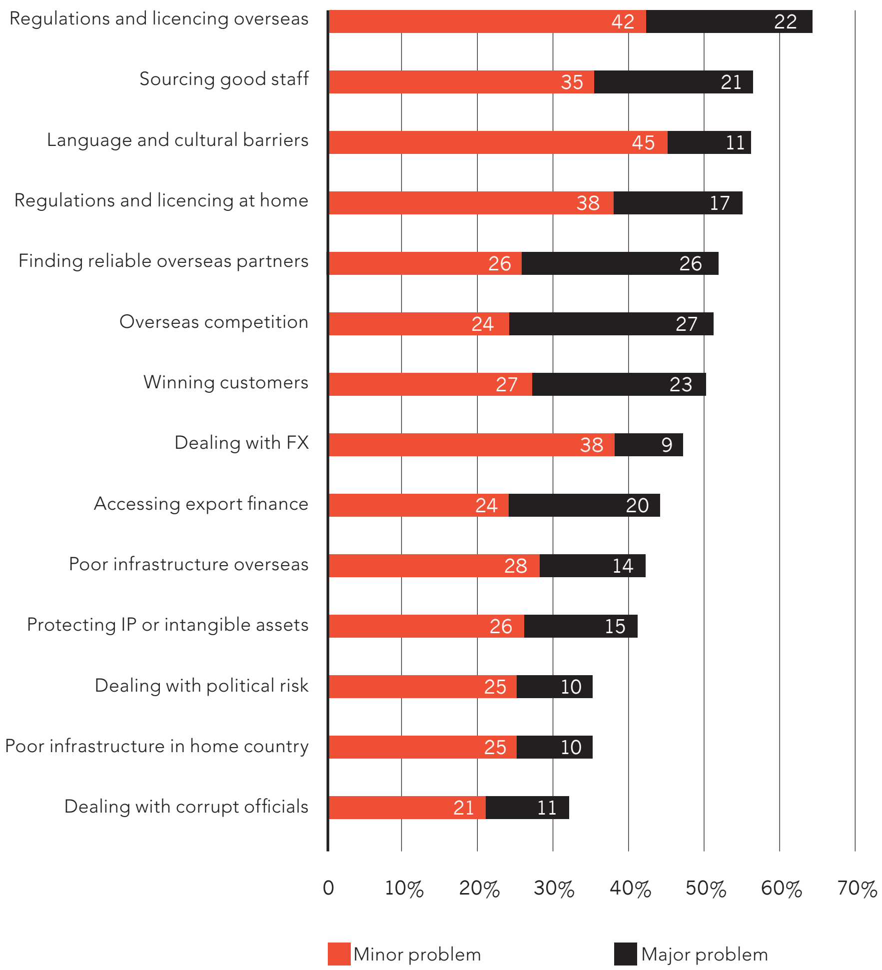
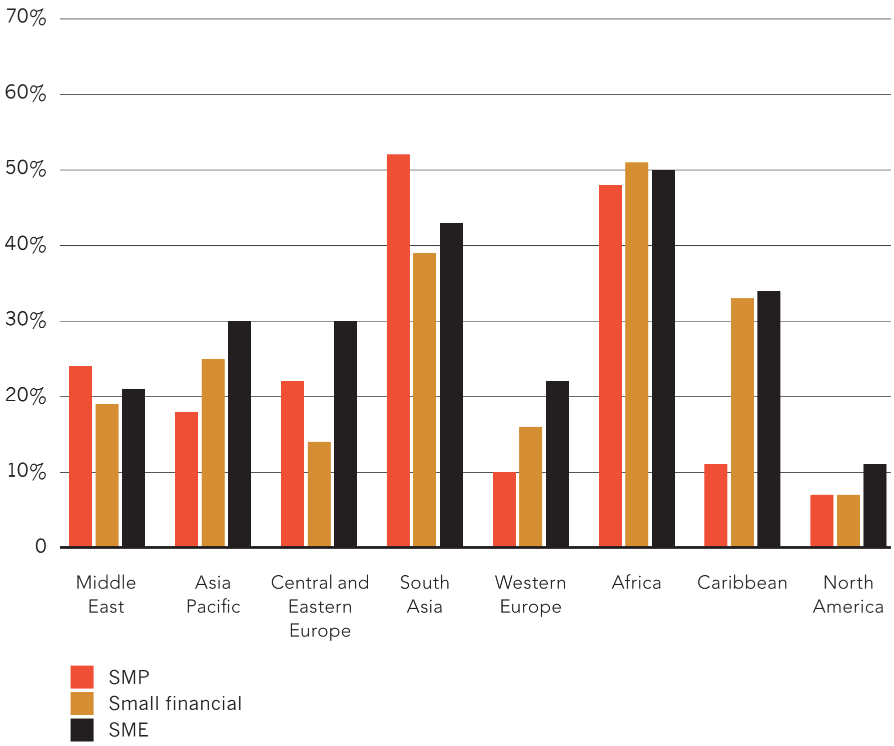


Figure 3.2: Percentage of ACCA and IMA members mentioning foreign exchange rates as a challenge for their business and clients, by region and sector (Q4 2011 to Q1 2013)



Further evidence of an FX blind spot comes from ACCA's Global Economic Conditions Survey (ACCA 2013). As Figure 3.2 shows, SMPs in most regions tend to be less concerned about the impact of fluctuating FX rates than are the general business population. This is despite the fact that the Global Economic Conditions Survey question is phrased so as to take into account the impact on clients as well as on the practice itself.[2] As might be expected, regions such as Africa and South Asia, where exchange rates make headlines on a regular basis, or the Middle East, or Central and Eastern Europe, where a lot of foreign-denominated trade and financing takes place, SMPs are as likely to cite FX as an issue as other SMEs. In other regions they are likely to underestimate it significantly, typically mentioning it half as often as other SMEs.

Finally, the Edinburgh Group SMP survey findings suggest that some currencies are harder to deal with than others – SMEs dealing in Yen appear to face the greatest problems, according to practitioners (114 SMPs in this sample had clients trading with Japan), while those dealing in US dollars also had more frequent (but less acute) problems with FX than others.

2. The precise phrasing is 'Q6.6 What have been the major outcomes for your/your clients' organisation as a result of the changes to the global economy over the last three months? (Please tick all that apply.):Negative impact of foreign exchange movements"

4. How do SMPs get involved?

SMEs are generally less inclined to pay external advisers for transaction support than for actual advice (Figure 4.1). Only 5.9% of SMPs in the sample were involved in FX transactions (either buying or selling), while 7.4% where involved in the management of exposures, from monitoring exposures and forecasting future needs or planning reserves to managing or hedging FX risk. Even allowing for the fact that not all SMPs had clients who needed such services, fewer than one-third of all SMPs with eligible clients (29.7%) were involved in trading or managing FX.

Further analysis reveals that SMPs' involvement in FX transactions increases with clients' involvement in overseas joint ventures and partnerships, and this type of SMP input was more common in emerging markets than in the developed world (Figure 4.3).

On the other hand, the key driver of SMPs' involvement in managing FX exposures on behalf of clients is the density of FX-exposed clients in their portfolio (Figure 4.2). Unlike transaction support, where it only takes one client dealing in FX to significantly increase the SMP's chances of being involved in buying and selling FX, management of FX exposure requires an investment in skills. Building this skillset is easier, and easier to justify, if a substantial number of clients are involved.

Figure 4.1: SMPs' involvement with foreign exchange transactions and exposures

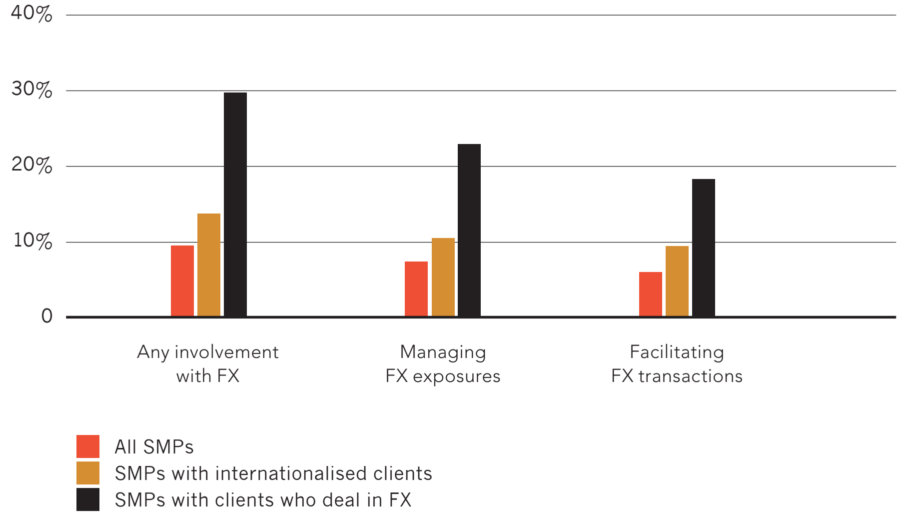


Figure 4.2: SMPs' involvement in FX, by general level of clients' internationalisation

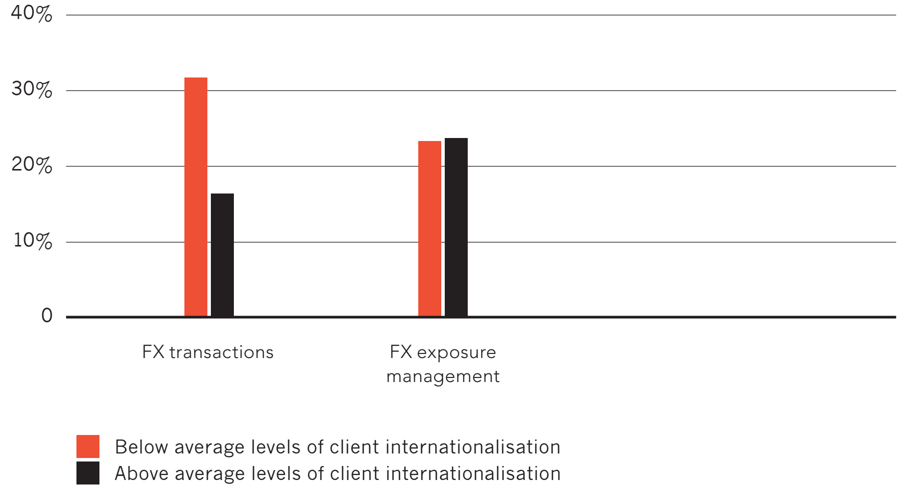
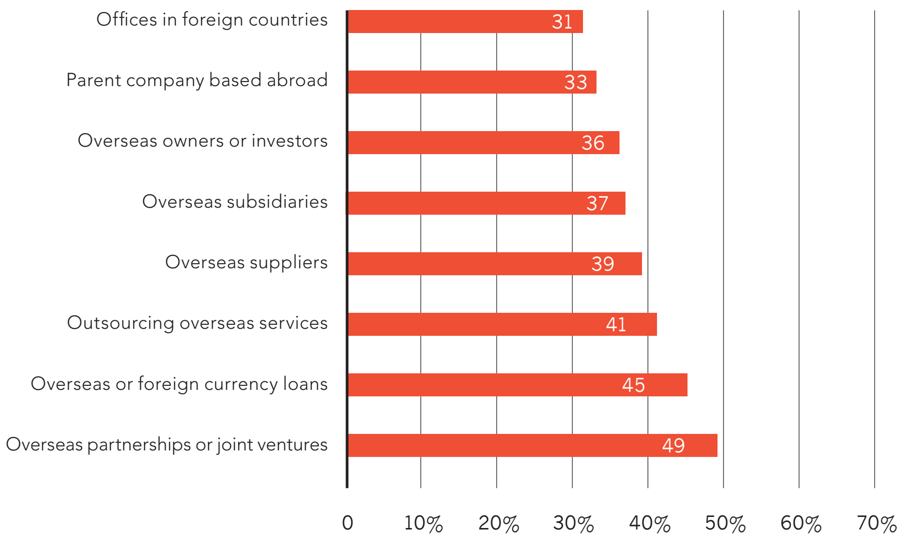


Figure 4.3: Third parties engaged on behalf of SME clients by SMPs involved in managing FX exposures



Finally, those SMPs without a substantial portfolio of clients dealing in foreign currencies can still get pulled into the management of FX exposures if some clients rely on significant financial flows from abroad – particularly if they have overseas owners or creditors, or if they have loans denominated in foreign currencies.

This combination of factors means that countries with a substantial presence of overseas banks and volatile currencies, and especially those with trading partners prone to protectionism, tend to have proportionately larger populations of FX-savvy practitioners. This combination occurs in many regions, from central and Eastern Europe, to East Africa and South America.

WHICH SMPS GET INVOLVED?

The analysis so far suggests that larger practices with more international clients are more likely to be involved in providing advice to SMEs that deal in foreign currencies. In practice there are also differences in the resources and motivations of practitioners that have a significant impact on their ability and willingness to provide such advice.

SMPs generally rely on internal resources more than any other input when giving advice on internationalisation – 68% of practitioners with international clients claimed to use these. When it comes to foreign currency issues and particularly the management of FX exposures, however, SMPs appear much more likely to turn to their business networks and overseas colleagues or subsidiaries. At the extreme, more than half of all SMPs who provide advice on both FX transactions and FX risk management use overseas colleagues or subsidiaries in order to advise their clients on internationalisation, and nearly three-quarters turn to their business networks (see Figure 4.4).

Owing to the phrasing of the questions involved it is impossible to know whether SMPs turn to these resources for advice on FX issues in particular. Nonetheless, it is also clear that practices involved in FX have greater access to external resources through professional networks.

Figure 4.4: Resources used in providing internationalisation advice, by level of the SMPs' involvement in FX

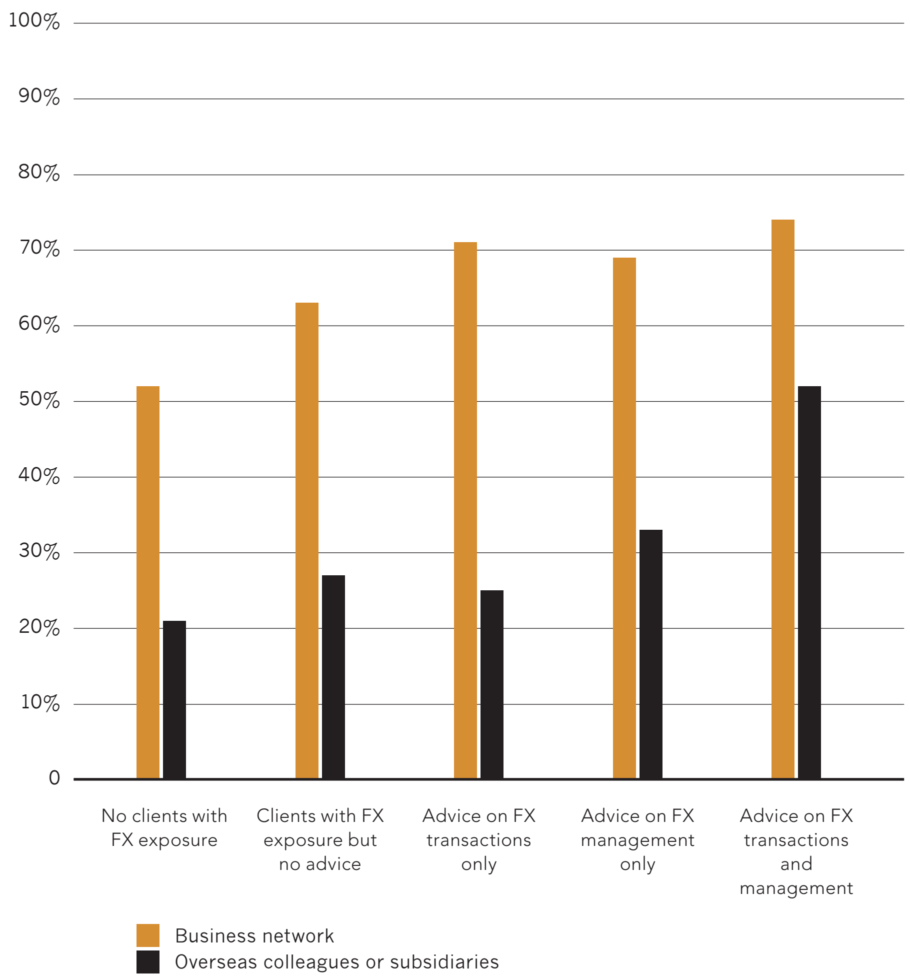
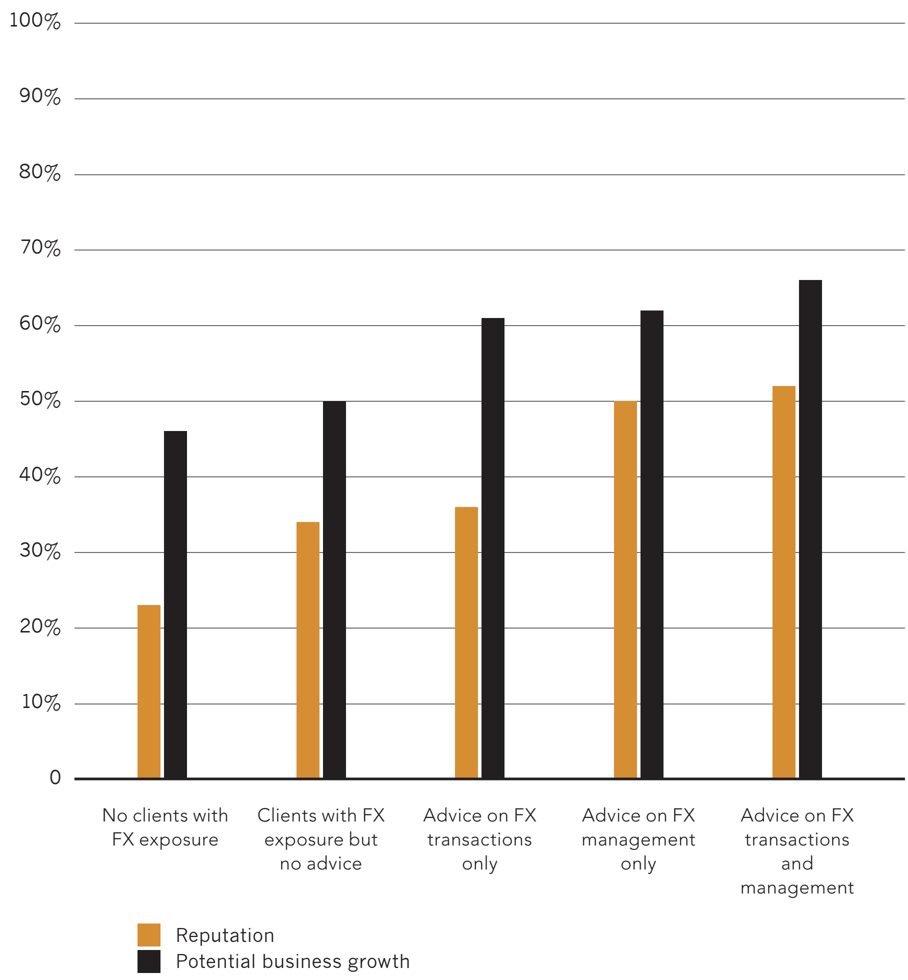


Figure 4.5: Motivations involved in providing internationalisation advice, by level of involvement in FX.



SME exporters tend to be larger, faster growing and more profitable, which in turn makes them higher value-added clients for small practices. As a result, potential business growth is a leading motivation for SMPs to engage with internationalised clients, with 46% claiming that it is a factor in their decision (Figure 4.5).

This percentage, however, grows with a practice's involvement in FX advice, rising to 66% among practices advising on both transactions and the management of exposures. Finally, the correlation between FX advice and practice reputation appears to be even stronger – practitioners involved in managing FX exposures are more likely to be driven by practice and personal branding, and over half reported this as a motivation for internationalisation advice.

5. Tips from the CEO: Kantox's Philippe Gelis

Philippe Gelis had six years' background in the consulting industry when he left Deloitte to create Kantox. His focus was on clients from the banking industry, such as Santander Group, and clients from the Venture Capital industry, such as PAI Partners or Palamon Capital partners. A French native, Philippe has an MBA from Toulouse Business School with a specialisation in corporate finance.

In the fast-moving, globalised economy, large corporates have learned how to adapt and maximise profits, while SMEs are usually not so well prepared. Trading globally is becoming commonplace for businesses but the associated FX risk is often not well understood or managed and SMEs are, as usual, much more affected than large corporates.

While FX hedging will always be highly dependent on context, including both company-specific factors and market dynamics, six simple rules can help business owners, and the practitioners who advise them, to approach the task correctly.

1. Define an FX hedging policy that is based on your risk appetite. If you want to hedge successfully, everyone in your company – board of directors, CEO, CFO, treasurer(s), accountant(s), etc – needs to know and share common targets and rules. Personally check that each board member has clearly understood the potential risks of the hedging policy previously defined. In some cases, board members prefer not to hedge the FX exposure to minimise costs and benefit from potentially favourable currency movements. Calculate worst-case scenarios and present the results to them.

2. Identify your FX positions and decide, on the basis of the hedging policy previously defined, whether they have to be hedged. It may seem obvious but to hedge successfully you need to know, at every moment, your exact FX exposure and its potential impact on your company's profitability and competitiveness.

3. Don't try to forecast currency movements or, at least, do not base your hedging decisions on currency movement forecasts alone. Do not forget that no one, including leading banks, is able to predict currency movements consistently, let alone forecast potential high-impact disasters on FX markets (think of Bear Stearns, Lehman Brothers, loss of the US AAA credit rating, Greece's sovereign debt crisis).

4. Never speculate with your corporate cash flows. Do not forget that hedging FX exposure is not the core business of your company. This means that in managing corporate FX risk you should aim to make neither profit nor loss but rather maintain a zero balance. Do not forget that not hedging FX risk is similar to speculating.

5. Buy only what you understand. Make sure you fully understand the financial products you use to hedge corporate FX risk (forward contracts, futures, options, exotics, etc). Buying derivatives is quite easy but understanding how they are built and the hidden related costs and risks is much more complex.

6. Avoid ad hoc data manipulations. It is so easy to add or forget a '0' when filling in data into a spreadsheet. Implement a treasury-management system. It may seem expensive, but only until your first big data mistake.

KANTOX'S VISION

Philippe Gelis

At Kantox we believe that the financial industry needs a radical rethink. Transparent, innovative financial services offering fair prices and creating no systemic risk are more important than ever. Inspired by vision, Kantox has developed an alternative to the traditional FX products and services offered by banks and brokers. This is a marketplace where companies can exchange foreign currencies with other companies, spot and forward, without the intermediation of banks. Hence Kantox is able to offer a simple, transparent and fairly priced FX solution.

Investors using Kantox include successful Web entrepreneurs and professionals coming from the financial industry with experience in companies such as BNP, HSBC or Deloitte. Kantox was founded in London in June 2011 and is regulated both by the HMRC (MLR 1264 1987) and by the FCA under the PSR 2009 (reference 580343) for the provision of payment services.

6. Conclusions

Internationalised and innovative SMEs are faster growing, more profitable and better able to create wealth and jobs than firms that have no international connections and do not innovate. They are also high-profile, high-value-added clients for any adviser, including professional accountants. Since the majority of these SMEs need to deal in foreign currencies at some point in their lifetime, it makes sense to ask whether small accountancy practices – SMEs' most trusted advisers – are well placed to offer advice in this area.

Yet findings from a large international survey of practitioners show that only a minority of SMPs are involved in clients' FX transactions or exposures in any way. In fact, it is possible that SMPs in many jurisdictions (especially in developed markets) may have a blind spot about the extent of SMEs' FX exposures and how exposed SMEs are to risk.

The survey findings suggest that SMPs' involvement in FX is likelier where there are significant cross-border flows of capital and corporate control. Foreign-denominated credit, joint ventures and cross-border partnerships frequently trigger such activity. In addition, many types of government and central bank intervention that are nominally meant to control the flow of capital and investment (such as the requirement for joint ventures with a local firm) could also be contributing to the demand for SMPs' services in this area.

Facilitating FX transactions (buying and selling foreign currencies) on the one hand and managing FX exposures on the other are two entirely different functions, and SMPs approach them in different ways. Managing FX exposures, in particular, requires a more specialist skill set and has a bigger impact on the reputation of an accountancy practice – indeed this appears to be a common motivation among practitioners who provide such services. A critical mass of internationalised clients is often required before practices become willing to provide such services formally.

Overall, it appears that practitioners could do more to support SME clients that deal in foreign currencies, and in theory they should have an incentive to do so. Nonetheless, this is only true provided that they are able to capitalise on their advice for branding purposes and convert the goodwill this advice creates into higher value added services as their international clients grow. Practices embedded in strong professional networks will tend to find this easier than those relying on internal resources alone.

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