
# Navigating Through Turbulence

Practical guidance for SME directors in uncertain economic times

November 2022

# Introduction

**2022 has been a rollercoaster ride for the SME business community. A brief window of post-Covid optimism rapidly dissipated following Russia's invasion of Ukraine in late-February. Since then, business confidence has remained deflated in the face of inflationary pressures, ongoing supply chain problems, labour shortages, and the impact of the Ukrainian conflict on global energy markets. Political instability and financial market turbulence have added to the mix.**

Although corporate insolvencies remain at historically low levels, SMEs face major challenges in the coming months if they are to survive or prosper. As an SME director, you may well be wondering how to navigate such uncertain economic times.

It's essential that directors face up to the challenges in a realistic manner, guided by meaningful information, robust boardroom discussions, and an objective decision-making process. This paper explores five key issues for SME Boards to focus on in the months ahead:

1. **Ruthlessly scrutinise the company's financial position, particularly its access to cash**
2. **Respond to the inflationary environment**
3. **Improve energy efficiency**
4. **Identify new revenue generating opportunities**
5. **Optimise governance**

### Some perspectives from IoD members

"Costs for us are sky-rocketing. Our supply chain in events was decimated through COVID and we've lost around 40% of capacity. People are proving hard to replace and raw material and energy prices are going up mid-contract. This is forcing us to put up our prices."

"Energy costs for manufacturers in particular are staggeringly high and we have no choice but to pass these costs on. In a global market this is significantly reducing our competitiveness."

"We are unaffected by inflation so far, but we are concerned that some of our tenants will have trouble paying their rent due to high energy prices."

"We have spent £60,000 Capital to buy solar panels and batteries to power our main property and its grounds."

"We are dealing with inflation by scrutinising all expenditure whilst also raising charges whenever possible. We are containing energy costs by turning off equipment previously left on standby and by preferring online meetings to travel. We have switched to 100% LED lighting and are studying changing to heat-pump heating. We are protecting cash flow by seeking pre-payment for work previously done before charging began."

"As a start-up we are keenly aware of costs, and very actively manage our cash flow with the directors lending additional funds to the business as required while we secure next stage development capital."

# The economic outlook for SMEs

## The wider economy

The economy grew strongly at the beginning of 2022 as the Omicron restrictions eased, but is now flatlining as consumers and businesses adjust to higher prices and worry about rising interest rates. To date, difficulties have mainly been on the supply side driven by shortages, a tight labour market, and rises in the cost of fuel.

The rate of inflation, as measured by the consumer price index (CPI), has risen sharply since restrictions were eased reaching double digits by the summer of 2022. Wage rates have also risen across the economy, but not to the same extent.

In August 2022 the Bank of England issued an economic forecast that predicted the economy would enter recession by the end of the year, driven by a slowdown in consumer spending caused by inflation rising faster than wages. Although the financial position of many households was bolstered by the pandemic, consumer confidence is at an all-time low, suggesting a slowdown is imminent.

Since then, the government has announced a price cap for domestic energy, one of the main components of CPI. This will put downward pressure on inflation and may improve the outlook for consumer spending depending on whether households view the overall programme of the government as positive. In the labour market, unemployment rose in the early pandemic but then reversed in 2021, hitting record lows of 3.6% by the autumn. Vacancies however remain much higher than before the pandemic, predominately because the number of people wanting to work has reduced by around half a million, leading to considerable recruitment difficulties for many firms. Vacancies have been particularly high in manufacturing and retail.

Britain's decision to leave the EU in 2016 reduced the flow of in-migration, but with the exception of certain specialist skill areas this has had less of an impact than the rise in economic inactivity across the population as a whole that is linked to the pandemic. The main reason that newly inactive people give is that they are long-term sick. However this is counteracted by an increase in people entering the labour market who previously said they were inactive due to family responsibilities suggesting remote working may have opened this up as an additional source of labour supply.

Official updates to economic forecasts are expected on 3 November (Bank of England) alongside an imminent forecast from the Office of Budget Responsibility designed to reassure markets that the government's overall plan to get a grip on the public finances is credible.

## Business sentiment

Confidence in the UK macroeconomy is very low, as measured by the IoD Directors' Economic Confidence Index. The main sources of concern are the rate of inflation, political instability, our trading relationship with the EU, and the international price of energy.

This has affected levels of investment; investment intentions among our members have fallen markedly in the last year. If in the months ahead inflation is perceived to have peaked, and the government is perceived to be more stable, then business confidence may however be expected to improve, particularly if the geopolitical situation does not deteriorate further.

## SME outlook

While there are particular problems in some sectors, particularly those most exposed to the rising price of energy (for example, manufacturing) and those most associated with discretionary consumer spending (for

example hospitality), across the economy as a whole we find that SMEs are still planning for growth, although the outlook is deteriorating

For example, our index of confidence in business leaders' prospects for their own organisations stood at +20 in September, a similar level to July. 26% of IoD members are planning to take on more staff in the next 12 months, compared to 15% who plan to reduce. 45% expect their revenues to be higher in the next year, 28% who expect revenues to be lower. All three of these measures have weakened over the course of 2022 but remain within a normal pre-pandemic level.

**Taken together, the top concerns of SME business leaders in September 2022 were:**

**55%**

**UK economic conditions**

**52%**

**Cost of energy**

**46%**

**Global economic conditions**

**42%**

**Skills shortages**

**37%**

**Trading relationship with the EU**

# The overall decision-making framework for SME directors

**Let's start with the basics. What is the Board of an SME actually there to do? Boards ultimately exist to take legal responsibility for the organisation and promote its success. The Board may hire managers to run the organisation on a day-to-day basis on their behalf. But in challenging times, the Board should not forget that it is ultimately responsible.**

The Companies Act 2006 defines a number of basic legal duties for company directors. The most prominent amongst these is section 172: that directors should promote the best interests of the company, and that the best interests of the company should be conceived as synonymous with the interests of shareholders. How shareholders will be affected by decision-making will therefore be a key reference point — at least for the directors of private companies.

However, section 172 also requires directors to go beyond a focus on the short-term financial performance. It asks them to pay regard to the implications of decisions for employees, suppliers and other stakeholders. It also states that they should consider the impact of their decisions on the company's reputation and long-term prospects.

However, the Board's perspective changes significantly if an enterprise can no longer continue as a going concern. If insolvency becomes an unavoidable prospect — and the organisation is no longer able to pay its bills — the Board is required by law to place the interests of creditors at the top of its list of priorities.

In such difficult circumstances, Board members will need to seek expert external advice from an accountant or financial adviser, and consider if the enterprise should continue trading or alternatively be placed into some kind of insolvency procedure, e.g. administration or liquidation.

# Specific issues for SME directors

**Five key tasks which the Board will want to undertake are as follows:**

## 1 Ruthlessly scrutinise the company's financial position, particularly its access to cash

This is a crucial activity for any Board as it will determine the survival or otherwise of the organisation. The Board should regularly review with management the near-term and longer-term financial impact of the emerging situation. Management assumptions underlying any revenue or cash projections should be fully understood and interrogated. Alternative financing arrangements should be explored on an ongoing basis along with ways of restructuring current debt obligations.

Boards may be forced to consider a number of ways in which they can safeguard their position by down-sizing their costs and boosting their access to cash. They may need to evaluate the pros and cons of:

- Reducing headcount and/or delaying recruitment plans.
- Scaling back or delaying investment or expansion plans.
- Closing down operations in parts of the business on a temporary or permanent basis.
- Restructuring the business, either internally or through merger/acquisition activity and asset sales.
- Re-evaluating relationships with suppliers.
- Seeking additional financial support, either from banks, investors, suppliers or government grants.

If cost cutting is unavoidable, then it should be undertaken in a sensitive and transparent manner, and with reference to the values and purpose of the organisation. In addition to fulfilling legal requirements, the Board of an SME will need to communicate a clear and compelling justification for the steps it is taking. This should take into account the impact on all of the company's stakeholders, not only shareholders.

Although tough decisions may need to be taken, a cost or headcount reduction process has the potential to affect the engagement of stakeholders, including those employees who are not directly affected. It is therefore important that the process is seen as in some sense 'fair' or justifiable.

However, the ultimate baseline for any business to continue as a going concern is a capacity to pay its debts. If it can no longer do that, then it is insolvent and can no longer continue in operation. Directors have a legal obligation to declare insolvency if such a situation has occurred or is likely to be unavoidable. In practice, this means that any company must always have access to sufficient cash, either within the business or from an external source, which is available to pay its bills. As the saying goes, 'turnover is vanity, profit is sanity, cash is reality'.

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## The challenge of late payment

One of the biggest threats to the cash position of SMEs is the problem of late payments. According to the British Business Bank, more than half (54%) of SMEs are suffering from this problem. As well as impacting on cash flow, late payments waste valuable management time in the chasing of unpaid invoices. And if those late invoices become bad debts, they can leave a business struggling to survive.

**In order to mitigate the risk of late payments:**

- Run credit checks on businesses before accepting them as new customers.
- Negotiate payment terms that suit your business from the start, e.g. after 30 days or including upfront or stage payments. Make sure that they are contractually defined. If a prospective client won't agree to your terms, it may be a red flag.
- Ensure that invoices are sent out promptly, do not contain any errors, and are easy to understand. Send your invoices to both the person who authorises the payment, and the person who actually processes it.
- Follow up overdue invoices promptly and consider using a software package that can automate invoicing and follow-ups.
- Develop good lines of communication with the administrator who processes your invoices. They may give you some insight into why any payment has been delayed. Avoid confrontational situations with debtors. They may also be having issues with late payments, and you risk alienating the people who owe you money.
- Contact the Small Business Commissioner[1]. Their office considers complaints from small businesses (those with fewer than 50 staff) about payment problems they are encountering with their larger business customers (those with more than 50 employees). They can make non-binding recommendations on how the parties should resolve their disputes.

[1] https://www.smallbusinesscommissioner.gov.uk/

## 2 Respond to the inflationary environment

Inflation is the number one concern for IoD members at the current time. It represents a direct threat to SME profit margins and may place the future viability of the business at risk.

In a broader macroeconomic sense, inflation undermines business confidence, as fears grow that consumers and businesses will reduce their spending due to deteriorating living standards, the prospect of rising interest rates and a worsening investment outlook.

Although consumer price inflation is currently running at 10.1% (in the year to September 2022), rates of inflation for many business input costs are much higher. Producer price inflation, which measures changes in the prices of goods bought and sold by UK manufacturers, was 20.0% in the year to September 2022.

Rises in energy costs have been a particular concern since Russia's invasion of Ukraine in late-February 2022. Although some companies were able to fix their energy costs at pre-war levels until well into 2023, many others have been less fortunate. Many companies renegotiating their contracts in recent months have been faced with annual energy costs two to four times higher than a year ago.

Employee wages are a major cost component for many SMEs. Although wages have not been keeping up with headline rates of inflation, they still rose by more than 5% over the last year at least in part due to continued prevalence of labour market shortages.

### Should SMEs increase their prices?

Attempting to absorb cost increases through reduced profit margins or by incurring financial losses will only be an option for the most resilient enterprises, with strong balance sheets and ready access to finance. On the other hand, seeking to pass on cost increases to customers is an option that will be viewed nervously by many SMEs.

If the demand for your products is highly price elastic, then you will need to evaluate price increases with caution. It may simply not be a viable step to take, given the resulting loss of business. On the other hand, products benefitting from low price elasticity can have their prices increased with a greater degree of confidence.

What will determine the price elasticity of your goods and services? This will need to be assessed on a product-by-product basis. However, various factors could play a role, including (1) the availability of alternatives, either from other suppliers or substitute products (2) whether the good is a discretionary purchase or a necessity, or 3) whether your product represents a significant proportion of customer income.

If you determine that a price increase is essential for your business, then it makes sense to influence customer perceptions of the increase with an appropriate communications strategy. You will want to justify the increase by highlighting the value of your product to the customer, its unique selling features and by communicating a sense that it represents an essential purchase rather than something that can be postponed. You may wish to add new features or benefits which further emphasise its value.

Simply informing customers that your prices are increasing because your own costs have increased is unlikely to be an effective strategy. The customer may see that as your problem and not necessarily a burden for them to bear.

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## 3 Improve energy efficiency

Energy costs are a growing component of costs for many SMEs, particularly in the wake of rising wholesale energy prices. Although the full impact of higher energy costs will to some extent be alleviated by the Government's recently announced energy support scheme for business, the Energy Bill Relief Scheme (EBRS), there still exist strong economic incentives for SMEs to reduce their reliance on expensive fossil fuels.

Furthermore, those fortunate SMEs that are currently benefitting from having fixed/hedged their energy prices at lower levels until next year should not rest on their laurels. At some point, they will almost certainly have to face up to much higher energy bills. The same logic applies to companies that will benefit from the EBRS over the next six months – as there is no certainty that such support will continue into the longer term.

In many cases, it makes sense to take action now to improve energy efficiency and thereby mitigate the impact of any future cliff edge in energy costs.

### Measures to improve energy efficiency[2]

- Change lighting to energy saving LEDs.
- Improve premises insulation.
- Switch to electric vehicles.
- Install a voltage optimiser which better matches the voltage of the energy supply to the requirements of machines and devices.
- Turn down thermostats in offices to no more than 19 degrees celsius.
- Implement a 'dead band' for heating appliances, with heating shutting off at 20 degrees and air conditioning switching on at 24 degrees.
- Consider investing in solar panels. This may involve additional investment in strengthening roof structures.
- Undertake a review of where energy costs are being most incurred across the business. This may involve installing smart meters attached to various appliances or premises.
- Consider replacing or better maintaining out-of-date equipment which absorbs excessive energy.
- Install heat recovery systems as a means of re-using existing heat in central heating systems.
- Change working patterns to avoid peak times in terms of energy prices (typically 4pm-8pm).
- Cut working hours or shifts, and/or reduce unnecessary operations. For example, in hospitality this might involve closing on quieter days during January/February.
- Evaluate the benefits of switching to a floating rate energy tariff rather than a fixed rate tariff, so that the company could benefit more immediately from any future decline in energy prices.[3]

[2] Further resources to assist you in improving energy efficiency can be found at: https://zerocarbonbusiness.uk/
[3] The energy regulator, Ofgem, has a useful collation of grants, schemes, and advice for SMEs on energy efficiency: https://www.ofgem.gov.uk/information-consumers/energy-advice-businesses/find-business-energy-efficiency-grants-and-schemes

## 4 Identify new revenue generating opportunities

The current environment is an opportune moment for SME Boards to evaluate new sources of revenue. This could involve brainstorming around a number of key questions:

- Which customer needs could you satisfy through the provision of a new product or service?
- Could you develop a product or service that is less expensive or of 'good enough' quality relative to existing products or market offerings?
- Could the delivery processes of existing products and services be improved – by making them faster, lower cost or more sustainable?
- Is there a way to make the benefits of existing products and services available to a wider group of customers – including those excluded from current market offerings?
- Could you leverage the strength of your existing reputation and brand into new markets or customer segments?

Once you have assessed potential opportunities, it makes sense to test viability by conducting market research. This need not be a lengthy or costly process. It could include using industry research to define the competitive landscape and determine your target audience. Or it may involve interviewing or surveying potential customers who fit your target demographic.

Gathering feedback from real people enables you to consider their attitudes and gain a deeper understanding of their likely buying behaviour. This can help you assess whether your potential product addresses a genuine market need and the likely size of the audience that could benefit from it.

## 5 Optimise governance

The purpose of good governance is to help organisations deliver sound decision making which is aligned with their purpose and values. SMEs have as much need of good governance as any other kind of organisation.

The primary governance mechanism for any organisation is the board of directors. In order to make well-judged responses to the coming challenges — either to protect the business or grasp new opportunities — it is essential that your Board operates with the right balance of skills, experience and boardroom processes.

In all but the smallest firms, a company's management will bear the day-to-day burden of managing the response to current challenges. The Board's role is nonetheless crucial. The Board is the body with ultimate legal responsibility for the organisation. Consequently, it needs to monitor management's actions, assessing whether management is taking appropriate steps and providing additional guidance and direction where necessary.

Non-executive board members have an important role to play. They can potentially offer a more neutral and objective perspective than may be possible for management. The latter will be immersed in solving the daily emerging problems. In contrast, NEDs can keep in mind the organisation's ultimate purpose, its values and the likely impact of decisions on a broad range of stakeholders. These are key qualities in the midst of a difficult situation.

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The Board will oversee management's efforts to identify, prioritise and manage the principal risks to business operations posed by the current environment. In a crisis situation, the Board will almost certainly need more regular updates from management between regularly scheduled board meetings.

A valuable task for the Board is to undertake scenario planning which considers the sensitivity of the company to various plausible developments and plans potential responses to each of them. The Board may also well wish to draw on the perspectives of external experts to help inform its analysis.

Depending on the situation, there may be new roles for one or more board sub-committees. These may be newly formed committees which are specifically targeted at specific challenges (e.g. cash management). Or new responsibilities may be allocated to existing committees, like the audit committee. The Board's consideration of, and decisions regarding, the key challenges should be recorded and justified in meeting minutes.

At an early stage, the Board should consider if it is appropriately organised to provide the right kind of guidance and oversight in the current circumstances. Are board members able to offer the necessary availability and time commitment as the situation intensifies? As well as considering if its own composition is appropriate, the Board should ensure that a succession plan is in place for the CEO. Similar plans should exist for other key managers.

The Board may need to consider if incentive or bonus plans need to be revised or suspended. They should also consider if appropriate behaviours are being encouraged by existing pay schemes. Ideally, remuneration policy during a crisis should encourage everyone to pull together in a highly cooperative manner.

# In summary

**SMEs face major challenges in the current business environment, particularly as a result of inflation and escalating costs. Although recent government interventions aimed at cushioning energy bills and reducing business taxes may be helpful to some SMEs, the responsibility for their survival and success ultimately rests with their directors.**

Directors that have a clear understanding of their duties as directors and a robust decision-making framework are more likely to be successful in navigating the turbulence of the next 12-18 months. For them, this will be a pivotal moment, when the foundations are laid for their future growth.

The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum, from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies. The IoD was granted a Royal Charter in 1906, instructing it to "represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation." The Charter also tasks the Institute with promoting "for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors", which the IoD seeks to achieve through its training courses and publications on corporate governance.

The IoD is an accredited Good Business Charter organisation.

**iod.com**

**For further assistance and advice, reach out to the IoD's Information and Advisory Service.**

The IoD's Information and Advisory Service is here to help you get answers. IoD members can access the latest information for small businesses, including legal and tax advice. Our resources cover everything from market research to finance and our experienced researchers will help you find exactly what you're looking for.

businessinfo@iod.com
+44 (0)20 3855 4313

**Authors**
Kitty Ussher, Chief Economist, IoD
Roger Barker, Director of Policy and Corporate Governance, IoD