# Q4

# FSB VOICE OF SMALL BUSINESS INDEX

## QUARTER 4, 2015

## Annual Review 2015

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Experts in Business

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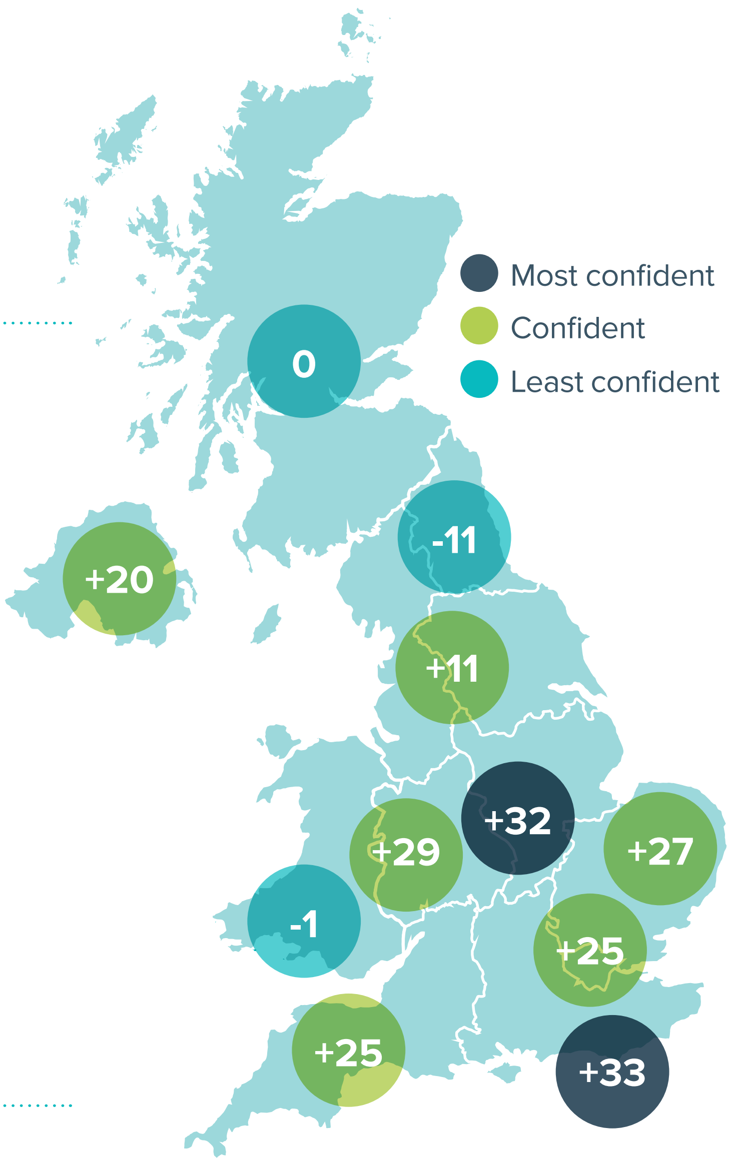
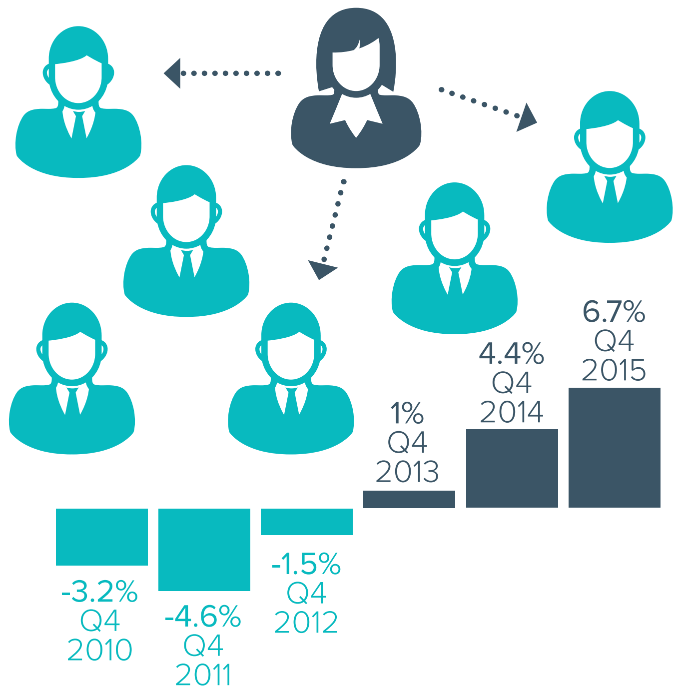
fsb Experts in Business

# Q4 2015
# SMALL BUSINESS CONFIDENCE

**"The Small Business Index shows a growing gap in confidence across the UK"**




## Small firms hiring new staff




## 1 in 4

**report tax burdens** as a barrier to business, **up from one in six** 12 months ago

## Investment intentions have fallen

## 22%

of small firms want to invest in capital down from **30%** across 2014

## Revenue growth highest since 2010

## 24%

**firms report revenue growth** in the last three months

# FSB NATIONAL CHAIRMAN

John Allan,
FSB National Chairman

To mark the fifth anniversary of the Small Business Index (SBI), this quarter's SBI is combined with a review of the business environment over the past five years plus a look at what smaller businesses can expect in future. The review has confirmed that smaller businesses are adaptable and resilient in the face of uncertainty and change with confidence remaining positive at +21.7 in the final quarter of 2015.

Confidence levels are strongest in the South East, Midlands, North West and Northern Ireland.

Government investment in the Northern Powerhouse is yet to bring welcome improvements to infrastructure and business opportunities. These benefits are yet to be felt across the north with the North East and Yorkshire recording the lowest confidence in England.

Confidence also remains low in Wales and Scotland. While all the devolved nations reported growth, their recovery remains fragile and could be set back by further cuts to public spending, especially if this results in job losses.

Of the sectors, professional business services and information and communication businesses are most confident this quarter and expect further growth. The largest drops in confidence are in transport and storage, and administrative support. Confidence in the real estate sector has dipped which is likely due to changes to tax rules which will potentially reduce sales and could constrain the availability of commercial property.

The falling confidence in labour intensive sectors like construction, manufacturing, and accommodation and food services is a likely reaction to rising labour costs which are a potential barrier to growth for more businesses than last year.

The availability of skilled workers continues to diminish and wages are therefore up on the same time last year. This is expected to continue, especially in sectors facing a shortage of skilled labour like construction. A shrinking labour pool could be further reduced by proposed changes to the tax treatment of contractors and a review of IR35. Contractors provide much-needed skills. Changes to the treatment of tax must be made for the right reasons and not stifle the use of contractors due to tax risk or undue administrative burdens.

The underlying favourable business conditions of the past year have helped businesses, with low inflation, energy and inputs costs remaining subdued. Average operating costs in 2015 remained lower than any other year quarter since 2011, although there are signs that they are starting to rise driven by rising labour and rent costs. These favourable conditions have supported productivity growth which is sitting at the highest level since 2010. There are further positive signs with around a quarter of members reporting revenue growth and expecting growth and rising profitability. The cost of finance has also lowered. While fewer businesses were successful in getting credit than in the previous quarter, the year-on-year trend shows external finance is getting easier to access.

With around a quarter of FSB members exporting, many are seeking opportunities in developing economies. Development of these markets is vital to counteract the sluggish European market. A refocused United Kingdom Trade Investment (UKTI) must provide smaller businesses with support to find customers and manage cross border legal requirements – although global economic headwinds and possible currency devaluation in China will pose further challenges for exporters in 2016.

Smaller businesses need time to adapt to incoming requirements, such as the national living wage, pension auto enrolment, and the tax treatment of dividends. The 2016 Budget needs to reduce, not introduce, burdens on businesses. The focus should be on driving the delivery of existing reforms and developing a simpler tax system along with a business rates system that is fair, transparent and flexible.

# ECONOMIST'S TWO YEAR FORWARD VIEW

Vicky Pryce, Chief Economic Advisor, Cebr

This review marks the five year anniversary of the SBI. The past five years has seen some tough times for the UK economy, and the next two years will offer both opportunities and challenges for the UK's growing force of small firms. It's great to see that the companies forming the foundation of the economy remain confident about their short term prospects, and certainly the business environment looks a lot more stable ahead than it has been over much of the past five years. Unemployment is back to pre-crisis levels, and the inflationary climate is likely to remain relatively supportive in 2016 and 2017.

That is not to say that it is absolutely smooth sailing to the horizon. The effects of slowing global trade and the lack of certainty around the outcome of the EU referendum will be felt in the UK, particularly for the one in four small firms that sells its products overseas. In addition, public sector austerity will be a key feature of the current Parliament, which will continue to constrain domestic demand. Lastly, low levels of joblessness cut both ways, helping to boost household incomes while also making it harder for firms to make new hires. Among small businesses, the latest SBI results show that the dwindling availability of skills is now one of the greatest barriers to achieving growth aspirations, and may become even more of an issue ahead. So new challenges are emerging, but, despite these headwinds, the UK economy is set to expand at a steady pace over the next few years.

One interesting trend to watch ahead will be what happens to productivity growth across the economy. Of course, much has been made of the fact that UK productivity is below that of many of its counterparts, including the G7 average. This is a structural issue that will take time and funding if it is to be addressed. But in the short term, we may start to see productivity per worker picking up at a faster rate in the next couple of years, as employment growth slows with the tightening labour market. Instead, firms will increase the hours available to staff – shifting workers from part time contracts and into full time jobs. Productivity per hour may also begin to pick up at a more robust rate as spare capacity dwindles, which as the latest FSB numbers show is certainly the case among small businesses. While we wait for productivity growth to accelerate across the board, it is encouraging to note that small firms are already achieving significant increases in their levels of output per worker.

Another key element that is likely to affect small businesses in a positive way over the next few years is the rise of alternative financing options, including crowd funding and peer-to-business lending. Currently, this is a very young industry, having only really emerged in the past few years. Peer-to-business lending stood at just £20 million in 2011 according to a Bank of England report, and is now worth £360 million in new lending per year. This astronomical growth rate shows no particular signs of slowing just yet. The latest SBI numbers indicate that only a relatively small handful of firms are using peer-to-business lending currently, but as the finance channel becomes both more widely known and accepted, it is likely that many more firms will start to take advantage.

This is obviously good for small firms for a number of reasons: an increased chance that they'll have their application approved; a greater choice of lending products; a likelihood of lower borrowing costs than more traditional routes. This last benefit will be particularly significant once the Bank of England starts to increase its base rates. As credit becomes more expensive all round, it will be hugely important for small firms to still have affordable access to financing. As the FSB numbers in this report show, more than half of firms apply for credit simply to ease their everyday cash flow, rather than for ambitious investments aimed at growth and expansion. Alternative finance provides options for businesses that need it, without which many would find themselves under greater pressure.

So what can we look for ahead? There is still considerable uncertainty in the global economic environment and not surprisingly, though the results of the rest of this report paint a picture of relative calm in the waters for small businesses, this is tempered with a hint of cautiousness. Firms are confident enough to continue increasing their staff headcounts, but capital investment intentions have cooled from last year, suggesting many have adopted something of a 'wait and see' approach, which may be with us for some time yet.

Q4

# FSB EXECUTIVE SUMMARY

## Key findings this quarter:

- **Small business confidence stood steady in Q4 2015 at +21.7,** broadly unchanged from the previous quarter and Q4 the previous year.
- **Within the headline number, a significant share of firms expects conditions to be roughly the same over the next three months, rather than worsen or improve: the largest share on record.**
- **A north/south split has emerged again in confidence readings.** London, the south of England and the Midlands remain generally optimistic, while the North of England and the devolved nations have become more pessimistic.
- **Business services and technology firms are the most optimistic, while real estate service companies have seen confidence take a knock.**
- **Revenue and profitability remains stable.** In line with flat confidence readings, businesses expect a similar performance in the three months ahead.
- **Steady growth continues to bring down spare capacity.** The case for a base rate rise at the Bank of England gets stronger as fewer small businesses report operating beneath capacity.
- **Labour costs and the challenge of finding skilled staff have risen notably as a potential barrier to growth.** Wage growth has accelerated as the labour market tightens – as such, this is more of a concern than the cost of energy, fuel and other inputs, which have all fallen back.
- **More firms expect to remain about the same size in 12 months' time.** With this being the case, investment intentions are weaker now than they were at the same point a year ago.
- **Financing is less of a cost to business and a less prevalent barrier to growth.** Fewer firms are applying for finance, but acceptance rates are rising and average interest rates offered are on the way down.
- **The inflationary environment currently remains supportive for bottom lines.** However, more firms are starting to report that their cost of operation rose over the past three months.

# REVIEW: UK MACROECONOMIC OVERVIEW – PAST FIVE YEARS

## UK economy nearing full capacity, but headwinds emerging

The UK economy has reached a point of fairly stable but gradually slowing growth, in a notable departure from the meandering path of expansion in recent years. This trend is expected to generally continue over the medium term, although some challenges ahead are emerging. This section of the report will look at how conditions in different aspects of the economy have evolved over the past five years, and how this could change in the near future.

## Economic output and growth: UK a star performer in 2014, but overtaken in 2015

Since 2010, changes in the size of the economy have wobbled between years of recovery and years where a fall back into contraction looked possible. Although it was eventually confirmed by the Office for National Statistics (ONS) that the UK avoided a 'double dip' recession, the unstable business environment made it very difficult to make long-term planning decisions. This was evident in business confidence statistics, both on the FSB's SBI and also those looking at the wider private sector, and the corresponding impact on business investment – which declined in 2012, for instance. Consumers were also feeling shaky, with household optimism falling back again after a brief post-recession peak in 2010.

With all this uncertainty, the UK was growing and recovering only gradually. It took until Q2 2013 for the size of the economy to become larger in real terms than its previous peak at the start of 2008.

This is an unusually long time for recovery, compared to other downturns in the last century. In addition, when looked at on a per head basis, GDP only reached its 2008 level in 2015, a seven year gap. As can be seen in the figure below, this is much longer than the average of three to four years for recessions in the previous few decades.

While it may have been a long road, the UK economy can now more or less say that it's recovered from the effects of the 2008-09 recession, at least in GDP terms. In fact, 2014 saw the strongest growth since 2005, which at 2.9%, was a faster increase than any other G7 member. In addition, the International Monetary Fund (IMF) s October World Economic Outlook suggests a continued robust expansion in 2015, pipped into second place only marginally by the USA.

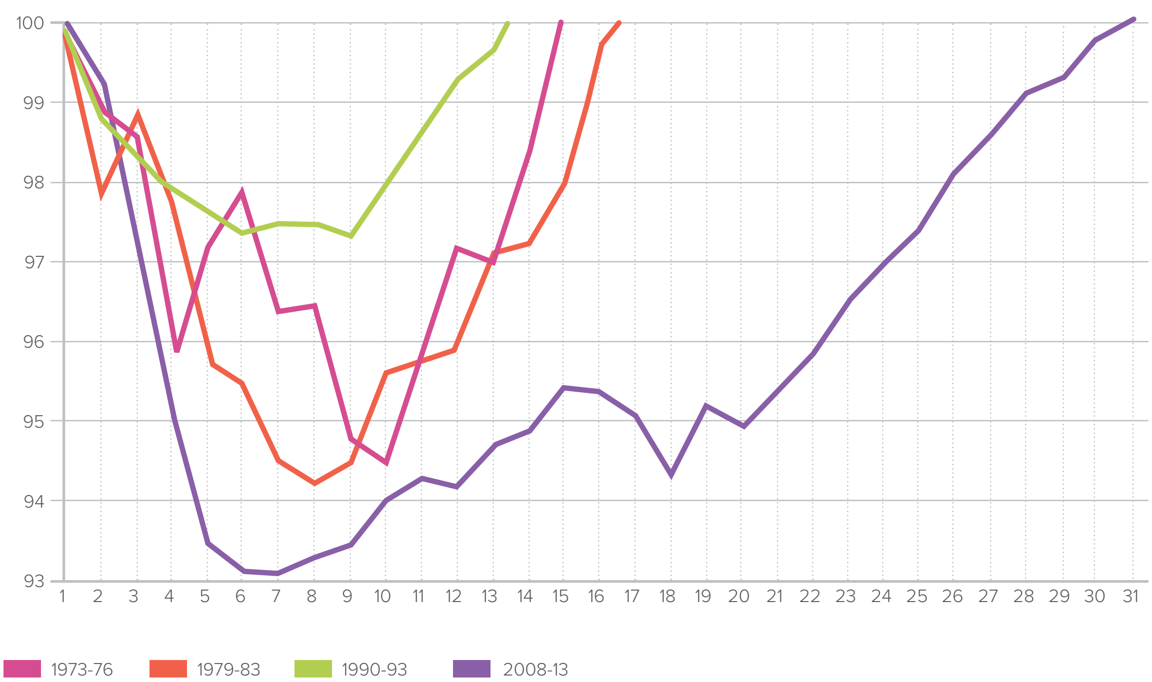



Figure 1:
UK recessions and recoveries. Real GDP per capita: time taken to re-gain pre-recession peak.

Source: Cebr analysis, ONS

## The labour market: the unemployment rate is down, but deeper analysis is required to get full picture.

As the 2008-09 recession began hitting its stride, joblessness in the UK climbed rapidly. The unemployment rate rose from an average of 5.3% in 2007 to a high of 8.5% at the end of 2011. Although this means that roughly one million people lost their jobs, the rate rose to less lofty heights than in previous downturns. In early 1993 for instance, unemployment hit 10.7% of the labour force, and 11.9% in mid-1984. This lower rate is despite the economy experiencing the sharpest contraction since the Second World War, and can be explained by a few factors.

Firstly, firms responded to the weakening economy this time around not by cutting headcounts back to the bare essentials, but rather by keeping people on with reduced hours. The percentage of people working part time stood roughly steady at 25% for much of 1995-2007, but this climbed quickly to a peak of 27.5% in 2012. Secondly, self-employment rose sharply, as workers that were laid off were either hired back as contractors, or newly-unemployed people set up their own businesses. By 2012, 14% of workers were self-employed, the highest since comparable records began in 1992.

One other way firms coped with weaker business conditions without making further redundancies was to hold back the pay growth. Between 2008 and 2014, average annual pay growth was just 1.7%, compared to an average of 4.3% over the rest of the 2000s, and to an average of 5.1% in the 1990s. To make things more difficult for household finances, the weak pay growth over the past five years came at a time of particularly rapid inflation, meaning that consumer spending power has seen its largest erosion in real terms since the 1930s and the Great Depression.

While the above typifies the labour market for much of the time since the financial crisis, conditions have been notably improving for UK workers in 2015. The unemployment rate started falling swiftly in 2014 and reached just 5.3% in Q3 2015 – in line with 2007 levels – and pay growth started quickly accelerating. Average wages rose year on year in Q3 by 3%, at a time when inflation stood at zero, meaning a significant boost to spending power.

However, looking beneath the headline unemployment figures shows that there is still slack available, and conditions are not quite as buoyant as might first appear. The share of those working part time that wish to work full time (the 'under-employment' rate) is coming down only slowly, and still has a long way to go before reaching pre financial crisis levels. A continued downward movement in this metric is likely to be one of the most notable UK labour market trends over the next year or two.

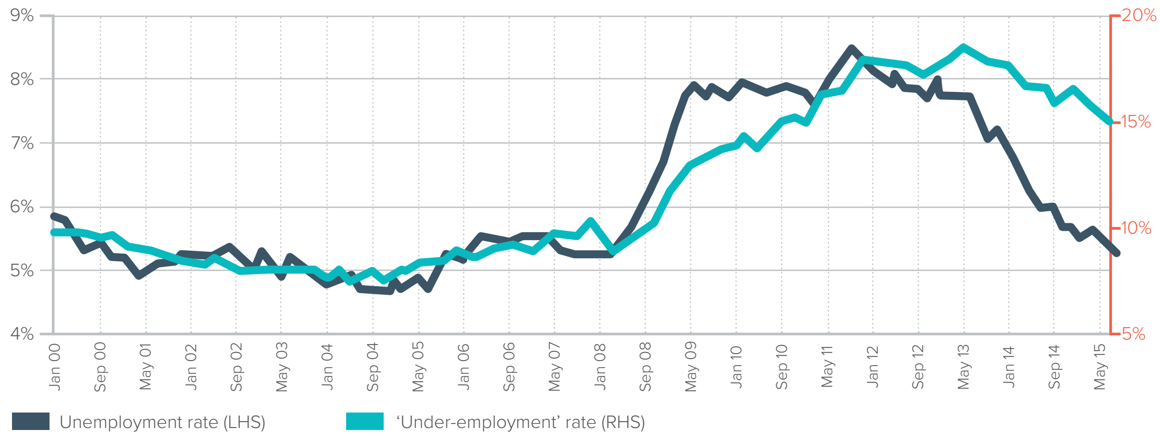



Figure 2:
UK unemployment rate and 'under-employment' rate, i.e. the share of those working part time that would rather be working full time

Source: ONS

The post financial crisis period saw two of the fastest periods of inflation in recent decades. Consumer price inflation stood at over 5% in both 2008 and 2011, a rate that previously hadn't been seen since the beginning of 1992. In large part, these substantial price increases were due to rapid growth in the cost of Brent crude oil, which reached its highest-ever level in 2008. This cost increase had direct implications for the price of vehicle fuel, and knock-on effects throughout the rest of the economy, raising the overall rate of inflation.

This period of rapid price growth weighed down heavily on household incomes in real terms, with inflation standing above wage increases for most of six years. Coming at a time of rising unemployment and generally low confidence in the economy, falling spending power served to further constrain consumption growth.

More recently, inflation has fallen swiftly and steadily, from 2.5% across much of 2013, to 0.5% by the end of 2014, and reaching an average of 0% across 2015 as a whole. This period of "no-flation" has helped to support the strongest period of growth in real incomes since the mid-2000s, boosting the economy in 2015 at a time of weakening exports and government spending restraint. One of the key factors currently holding down the inflation rate is the price of energy, such as petrol and home gas, as the cost of Brent crude oil fell by more than half in 2014. The other is the cost of food, as increased competition in the supermarket sector has forced prices significantly down – a trend that is ongoing in late 2015, as shown in the figure below.

Looking ahead, inflation is likely to start slowly rising again in 2016, as the effect of last year's drop in oil prices falls out of the annual comparison. With this downward pressure diminishing, consumer price inflation is likely to reach towards the 1.5% mark by the end of 2016.

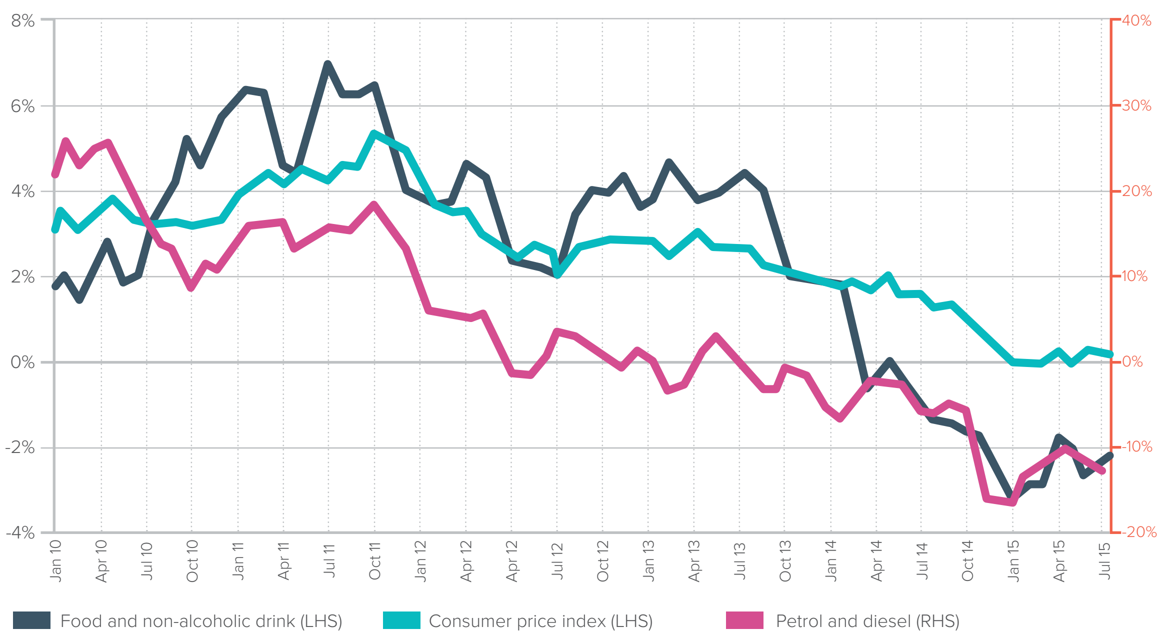



Figure 3:
UK annual inflation rates, overall and by category

Source: ONS

## Government finances: budget deficit is falling, but a long way to go to reach surplus

Discussion on public sector finances over the past five years has largely centred around the concept of austerity. The current Parliament started with net borrowing of £153 billion for the 2009-10 fiscal year, and has since made efforts to reduce this. The borrowing gap stood at £84 billion for the 12 months to October 2015, showing that some progress has been made.

Recent austerity has been more to do with keeping budgets on hold in real terms, or growing only slowly, rather than making actual reductions in overall spending. For instance, over the past five years, total government consumption increased in real terms by 5.4%, according to national accounts figures from the ONS. Once population growth of about 3.5% over the same time frame is taken into account, this equates to only a very small increase in spending per person in the last half decade. For comparison, government consumption rose in real terms by 19% between 2000 and 2005 – nearly four times faster.

So with no notable cutbacks in total government spending, it has been up to tax receipts to close the gap in the public sector deficit. As described earlier in this report, economic growth in the past two years has put in a strong performance, and with rising output comes rising tax revenue. Total receipts rose over the last five years by 20% in nominal terms, well above the 15% seen in the previous five years (2005 – 2010). This is lower than the 25% seen in the 'boom' years between 2000 and 2005, but given the past half-decade has seen some tricky years for economic growth, it's not too surprising. In addition, this increase in tax revenue has come despite the main rate of corporation tax being lowered from 28% in 2009/10 to 20% in 2015/16, and a significant increase in the amount of income that is tax free for individuals.

At November's Autumn Statement, the Chancellor presented the Office for Budget Responsibility's (OBR) latest outlook for public finances based on the Treasury's spending plans. This forecast suggested that the government will still be borrowing £50 billion in 2016-17, falling to a marginal deficit of £4.6 billion by 2018-19, and reaching a surplus of £10.1 billion by 2019-20 as illustrated in the figure below. These projections are based on the OBR's in-house projections for economic growth, which average just under 2.5% over the years to 2020. However, many believe these forecasts to be over-optimistic. For instance, the Treasury collects a selection of independent forecasts each month, and the average of these for the period is closer to 2%. Cebr believes that growth could even dip beneath the 2% mark for some of this forecast horizon. Slower economic expansion would lead to a weaker increase in tax receipts, which if spending plans are kept unchanged is likely to mean that it will take longer for a surplus to be reached.

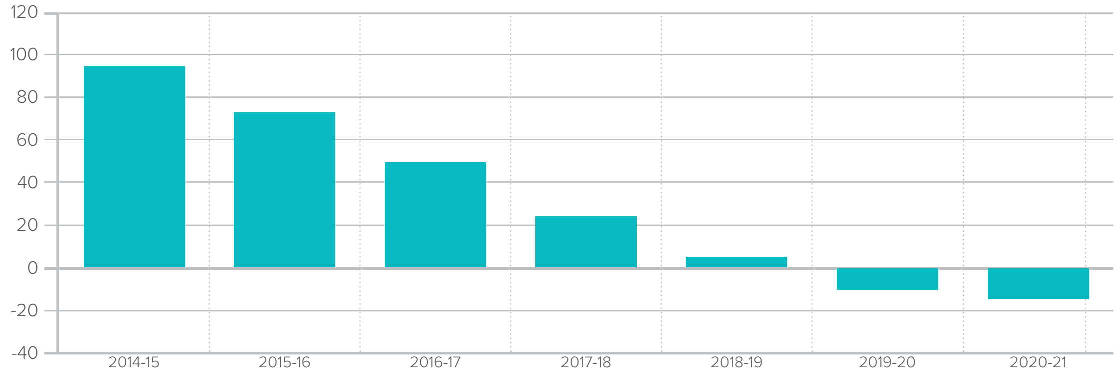



Figure 4:
UK public sector net borrowing forecast, £ billions

Source: Office for Budget Responsibility

## Exports: Constrained by sluggish growth in the Eurozone

Export performance has been one area that has particularly disappointing in recent years, rising in total by 15% over the past five years. While this is faster than the 10% seen during the 2005-2010 period, when global trade was collapsing, it is much weaker than that seen in previous years: between 2000 and 2005, exports grew by 21%, and the half decade before that saw an increase of 34%.

One of the key factors constraining growth in overseas sales in this time period has been the sluggishness of the Eurozone economy, where output is currently only roughly equal to the previous peak in 2008, meaning seven years of essentially zero growth. The UK still sends roughly half of its goods exports to the Eurozone and more than a third of its services exports. As such, the performance of the single currency area has notable knock-on effects for the UK. This is compounded by the fact that the pound has strengthened notably against the euro since almost reaching parity in 2008.

Growth in other areas of the world has proved more promising however, both in emerging markets and in the developed world. In the past six months (to September 2015), exports of goods to China rose by 25% over the same period a year before, and by 31% to India. Although growth in China's economy and its demand for UK products is slowing, this is still a substantial boost to exporters' prospects. In addition, the value of goods exports to the USA, South Korea, the Middle East and Switzerland have all seen robust increases recently, as illustrated in the figure below. This compares to a notable reduction in goods exports to the EU, as well as declines to Hong Kong and Japan.

Looking ahead, weaker global growth in 2016 is likely to weigh down on the UK's export potential for the year ahead. Beyond then, prospects are a bit brighter as the world economy gains momentum again, but a weak Eurozone is likely to be a key feature affecting exporters for some years to come.

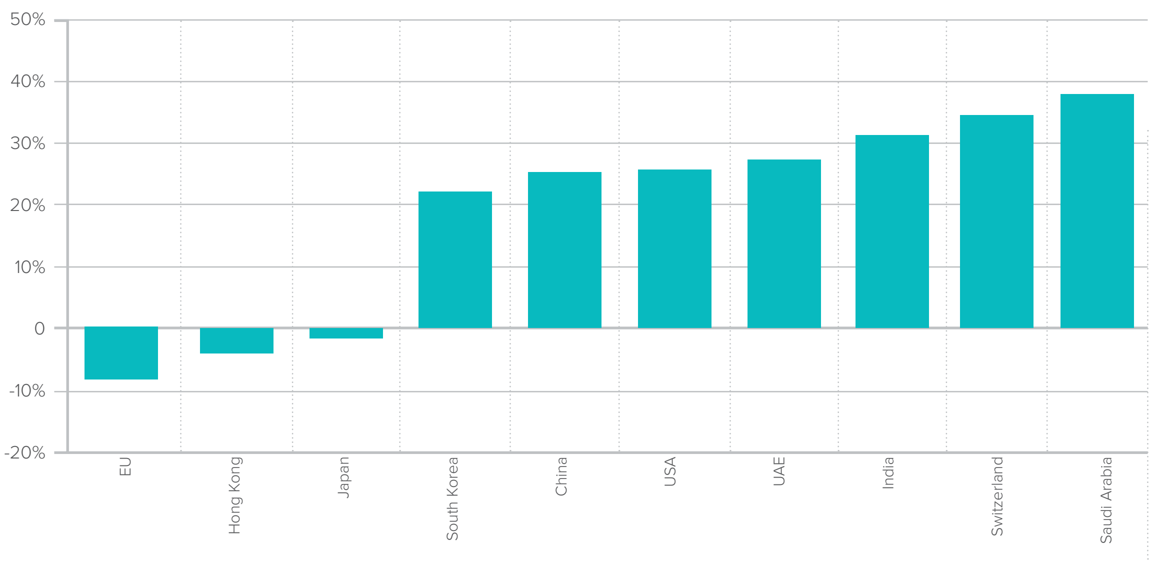



Figure 5:
Year-on-year growth in goods exports to UK's 10 largest markets, past six months average

Source: HMRC, Cebr analysis

## Devolved nations: Growth remains well behind England

In general, economic conditions in the devolved nations remain notably weaker than for England and as such, the UK as a whole. The latest data available for each of the countries is Q2 2015, which shows that the economies of Wales and Northern Ireland expanded by 1.3% year-on-year, while Scotland grew by 1.9%. This compares to a UK-wide figure of 2.4%, implying a higher-still figure for England alone.

For **Northern Ireland**, economic growth picked up at the end of 2014, following some weak results earlier that year and in 2013. However, there are signs that this expansion remains on unsteady foundations: employment growth has fallen back across 2015 and actually fell by 0.6% over the year to Q3. The country remains at risk of being particularly adversely affected by government spending cuts over this parliament, as still more than one in four workers are employed by the state, which is planning job cuts. However, the recent decision announced in the Autumn Statement to make no immediate changes to the tax credit system is good news for the 120,000 households in Northern Ireland that were estimated to have been adversely affected. These households will now be able to support consumer spending to a greater extent than would have been the case.

This latest result for **Wales** follows a generally steady growth performance, with output in the private sector economy expanding at a roughly similar level for a few years. However, this stable growth path masks a more turbulent outturn in the labour market. Employment levels were falling back sharply in 2014, with total headcounts down 3% year on year in Q4. However, in 2015 this trend recovered: around the middle of the year, employment was rising by some 4% compared to 12 months before. The Welsh economy also appears relatively fragile and is particularly at risk of feeling the effects of government cutbacks. One sign on the ground of low confidence levels is that house prices are rising at the slowest rates in the UK, and the labour force was smaller in Q3 2015 than a year before.

The picture for **Scotland** is slightly different to that of the other devolved nations. The Scottish economy had been growing at pretty robust levels towards the end of 2014, at over 3% year on year, but the latest results represent a significant slowdown. The sharp drop in the price of oil has dramatically impacted the oil extraction and refining sector, with output down over the year to Q2 2015, although this is a relatively small part of the economy. The more significant driver of the overall slowdown is the services sector, where the growth rate in mid-2015 is just a third of that seen at the same point in 2014. Despite this current weaker performance, the Scottish economy has recovered well from the 2008-09 downturn, surpassing its pre-crisis peak in aggregate real terms at the start of 2014.

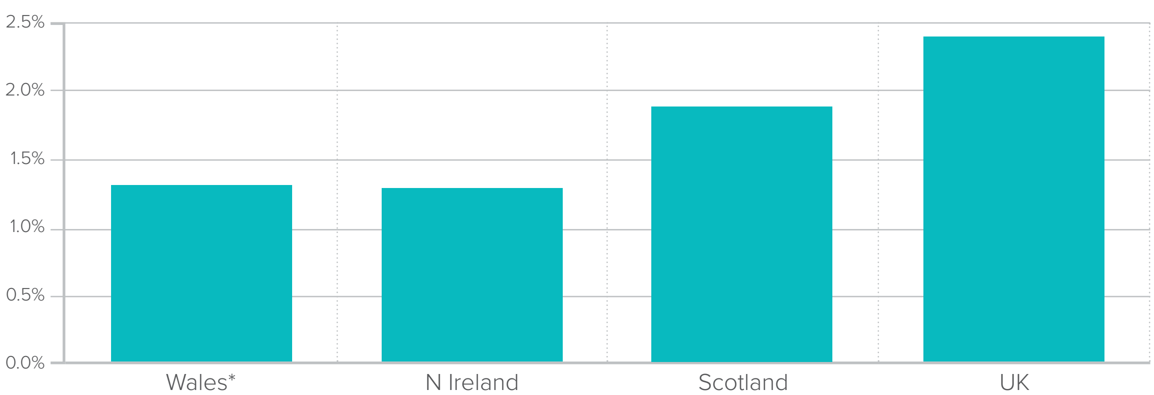



Figure 6:
Year-on-year growth in economic output, Q2 2015, by area

Source: ONS, Stats Wales, Detini, Scottish Government, Cebr analysis. * Private sector estimate only

# LATEST RESULTS AND FIVE YEAR RECAP

## Small businesses expect stable growth conditions

This quarter, the SBI climbed to +21.7, from +20.3 in Q3 and from +17.6 at the same point a year ago. This suggests that businesses are buoyant in general about business conditions in the three months ahead, and are marginally more confident than they were last quarter. This is good news, coming as it does at a time when the UK economy looks to be gradually slowing, but still following a reasonably steady growth path.

Looking deeper into the Index results further highlights these stable growth conditions. This quarter, 44% of firms report that they expect business conditions to remain about the same over the next quarter, rather than improve or worsen. This is the highest share reporting this sentiment since the series began in 2010, suggesting that growth will remain at similar levels to now, at least in the short term. The OBR is one forecaster projecting a flat growth trend in the coming years, expecting the economy to expand each year in the range of 2.3% - 2.5% until 2020.

This latest result, as well as those over the past year, are a marked contrast to the confidence levels seen when the survey began, five years ago. Negative Index readings were recorded six times between 2010 and the end of 2012, with most of the other quarters showing only weakly positive at best. However, since the beginning of 2013, optimism has regained positive ground and remained relatively robust.

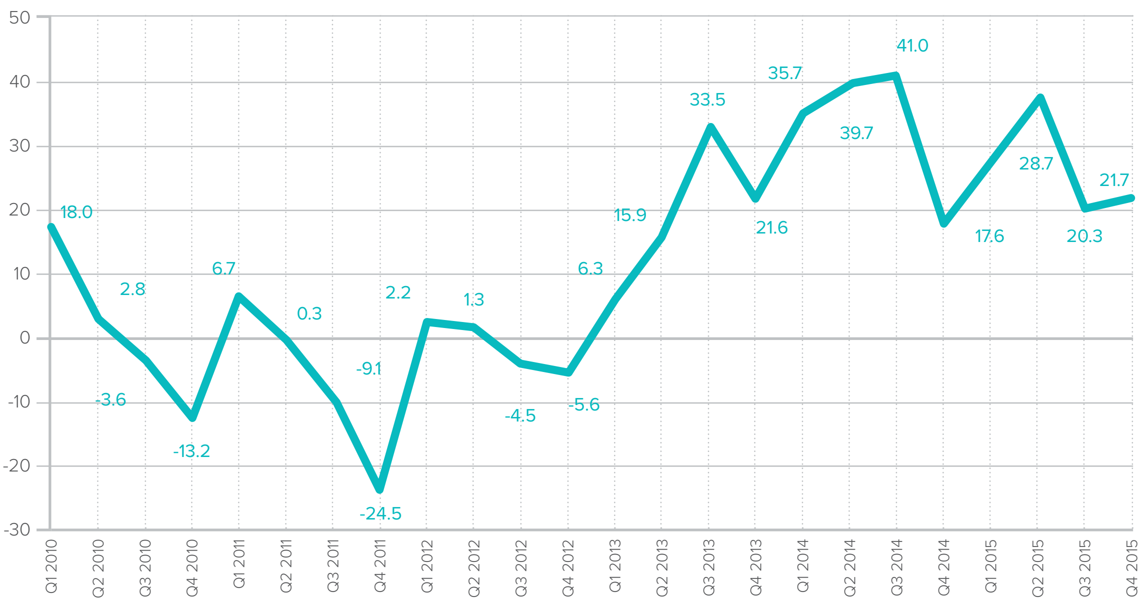



Figure 7:
The FSB SBI[1]: small business prospects over coming three months

Source: FSB SBI/Annual Review Q4 2015.

1. The SBI is a weighted index of the responses to the question: 'Considering your overall business performance, and ignoring any normal seasonal variations at this time of the year, how do you view business prospects over the next three months, compared with the previous three months?' The share of firms reporting 'much improved' are given the following weightings: +2, slightly improved +1, approximately the same 0, slightly worse -1 and much worse -2; the Small Business Index is derived from the sum of these factors.

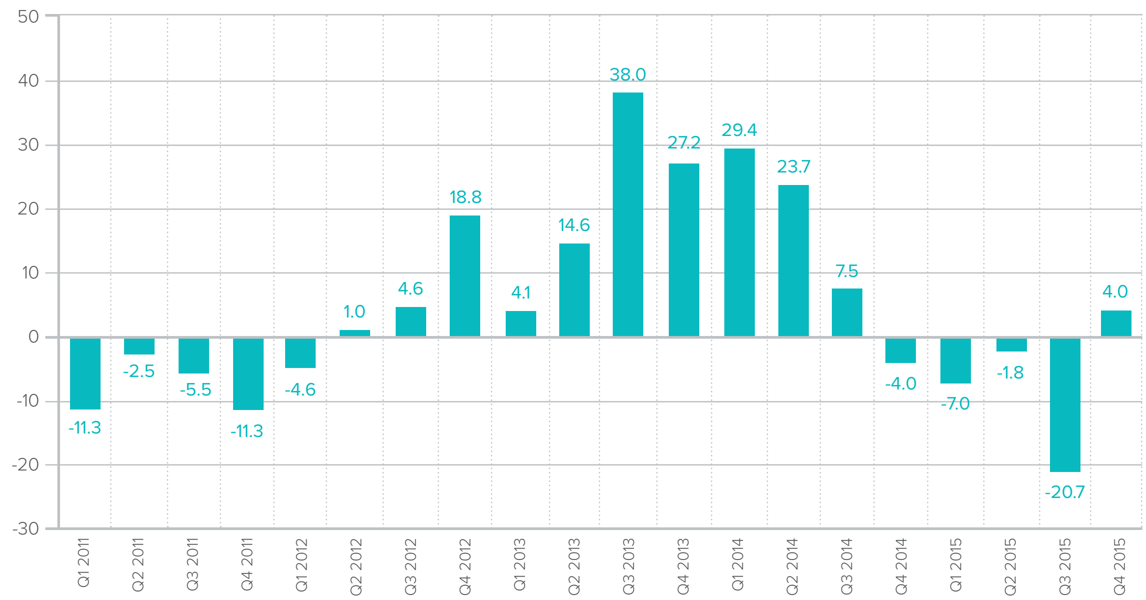



**Figure 8:**
Year-on-year change in the FSB SBI

Source: FSB SBI/Annual Review Q4 2015.

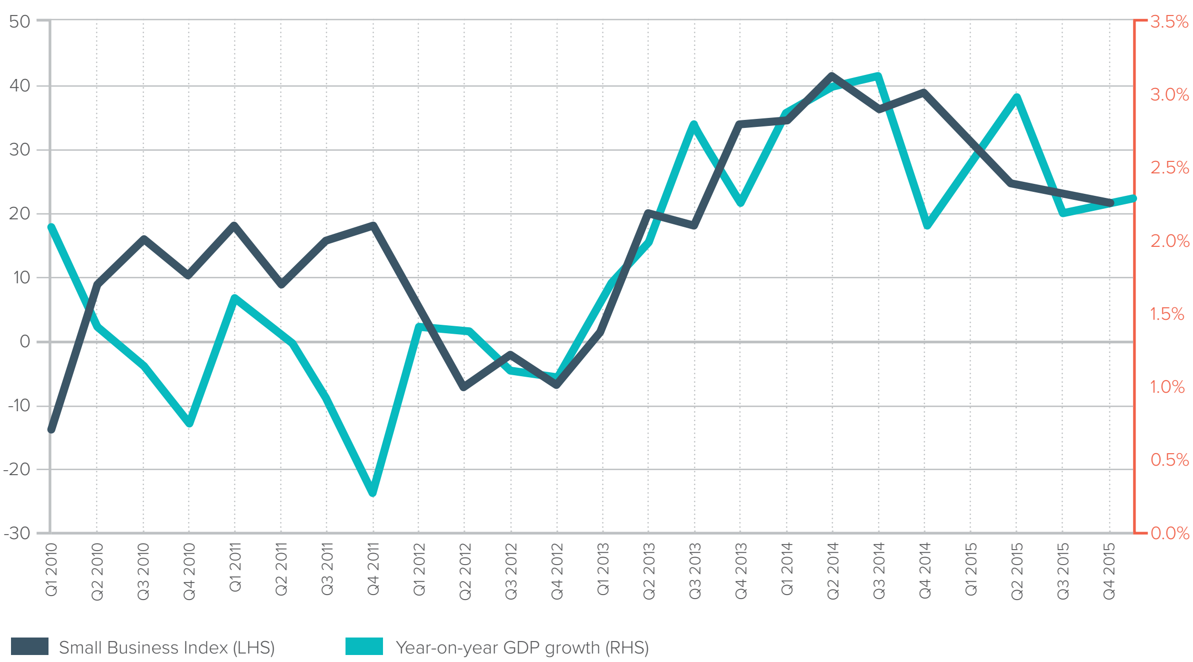



**Figure 9:**
Year-on-year GDP growth and the SBI

Source: FSB SBI/Annual Review Q4 2015, Office for National Statistics, Cebr analysis

# REGIONAL SMALL BUSINESS INDICES

Small firms in the South East are the most confident in the UK

# NORTH-SOUTH SPLIT IN CONFIDENCE EVIDENT THIS QUARTER

Although confidence is up across the UK as a whole, the same cannot be said for each country and region. Optimism levels are up or flat in six areas, but the rest have seen a year-on-year decline. The key thing evident from the Index readings this quarter is the split between confidence in the South of England and the Midlands, compared to those in the North of England and the devolved nations.

Small firms in the South East are the most confident in the UK. This reflects particularly strong local economic conditions: the unemployment rate in the region dropped to just 3.9% in Q3 2015, lower than any other area. The Midlands are also seeing buoyant optimism levels, coming just behind the South East on the SBI. This again indicates a supportive trading environment, with joblessness in these areas dropping sharply over the past year, helping to boost consumer spending power.

At the bottom end of the scale (as highlighted by the figure below) stand the devolved nations and the regions of northern England. The confidence index for the North East was just -11 this quarter, well below any other part of the UK. Business conditions are particularly difficult in this region, with unemployment at 8.6% holding well above the national average of 5.3%, and increasing over the past quarter. Wales and Scotland have the next lowest optimism readings, at just -1 and 0 respectively. Again, labour market conditions in these countries serve to highlight the fragile health of the local economies, as unemployment has risen quarter-on-quarter recently, eroding confidence and households' ability to spend. Optimism in the North West is higher in the latest results than a year before, potentially buoyed by on-going announcements on investment in the Northern Powerhouse.

These latest readings tend to reflect the state of the nation as seen in general over the past five years. The South East has typically had one of the highest small business confidence readings since the series began, while Wales and parts of Northern England have often appeared at the bottom of the list. The North and devolved nations have both been hit hard since the 2008-09 recession, with government cutbacks coming at the same time as a weaker business sector, making trading conditions difficult. This compares to London and the surrounding area, which has been much more buoyant, benefitting partly from the capital's position as a leading global hub for business.

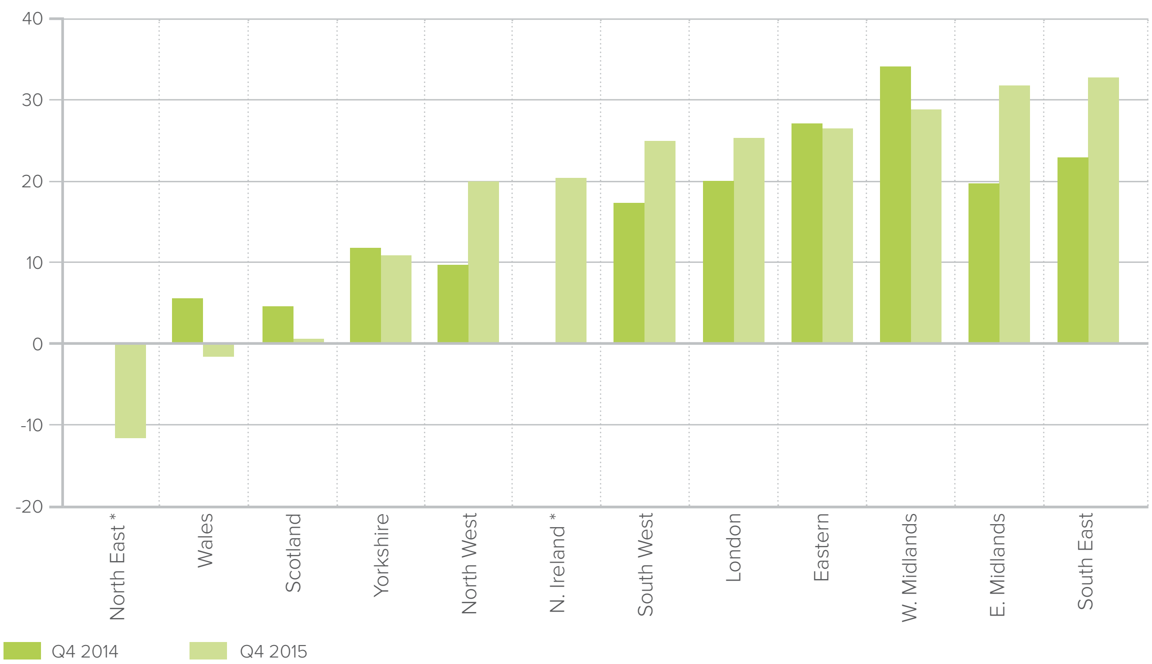



Figure 10:
FSB SBI – regional variation in small business prospects over coming three months

*responses unavailable for Q4 2014 due to sample size limitations. Source: FSB SBI/Annual Review Q4 2015.

# SMALL BUSINESS SECTOR INDICES

Small businesses in the real estate sector have seen a dip in their confidence readings over the past year

# BUSINESS SERVICES AND TECH FIRMS ARE MOST OPTIMISTIC, WHILE REAL ESTATE AND AGRICULTURAL SECTORS TAKE A CONFIDENCE KNOCK

This quarter, small firms in the business services industry (defined by the ONS as 'professional, scientific and technical activities') are the most confident, with an Index reading of +40. This is up from +31 at the same point a year ago, and follows a particularly strong performance for the sector. According to ONS figures, the professional services sector (law, accountancy, engineering) expanded year-on-year by 5.6% in Q3 2015 – double the rate of the overall services industry. The sector is closely followed in optimism by small firms in the information and communication sector, with an Index reading of +34. This technology sector has seen even faster growth, at 8.1% for 'information service activities' over the year to Q3 2015. The UK is establishing a good track record for this industry and as such, it is likely to be one that continues to drive growth ahead.

Looking at the bottom of the scale, small businesses in the real estate sector have seen a dip in their confidence readings over the past year. This comes alongside changes in taxation rules regarding house purchase and ownership: December 2014's Autumn Statement saw a change to stamp duty, making it much more expensive to purchase a prime property; July 2015's Budget made it more expensive for landlords to own properties by reducing mortgage interest tax relief, and November 2015's Autumn Statement increased stamp duty for individual buy-to-let investors. Each of these measures may make business conditions more difficult for those in the real estate sector, and certainly the London property market has seen a marked slowdown over much of the past year on the back of higher stamp duty costs. Small firms in the farming, forestry and fishing sector have also seen a decline in their confidence over the past year, potentially reflecting shrinking output: the latest ONS figures show that the sector shrank by 0.1% over the year to Q3 2015.

Over the past five years, it has typically been both business services and information and communication businesses that have competed for the top spot in the rankings of business confidence by industry, highlighting the importance of these sectors to the UK economy. A sector that has been much more pessimistic over the span of the Index is the hotel and restaurant industry, which has often placed towards the bottom of the confidence rankings. This is likely to do with the fact that household finances have been severely squeezed since the 2008-09 recession, with the cost of essential items rising significantly, giving consumers less money to spend on eating out and staying away from home. However, one thing to note is that with inflation standing at around zero for most of 2015, the confidence of small firms in the restaurant industry has climbed over the past year, alongside consumer spending power.

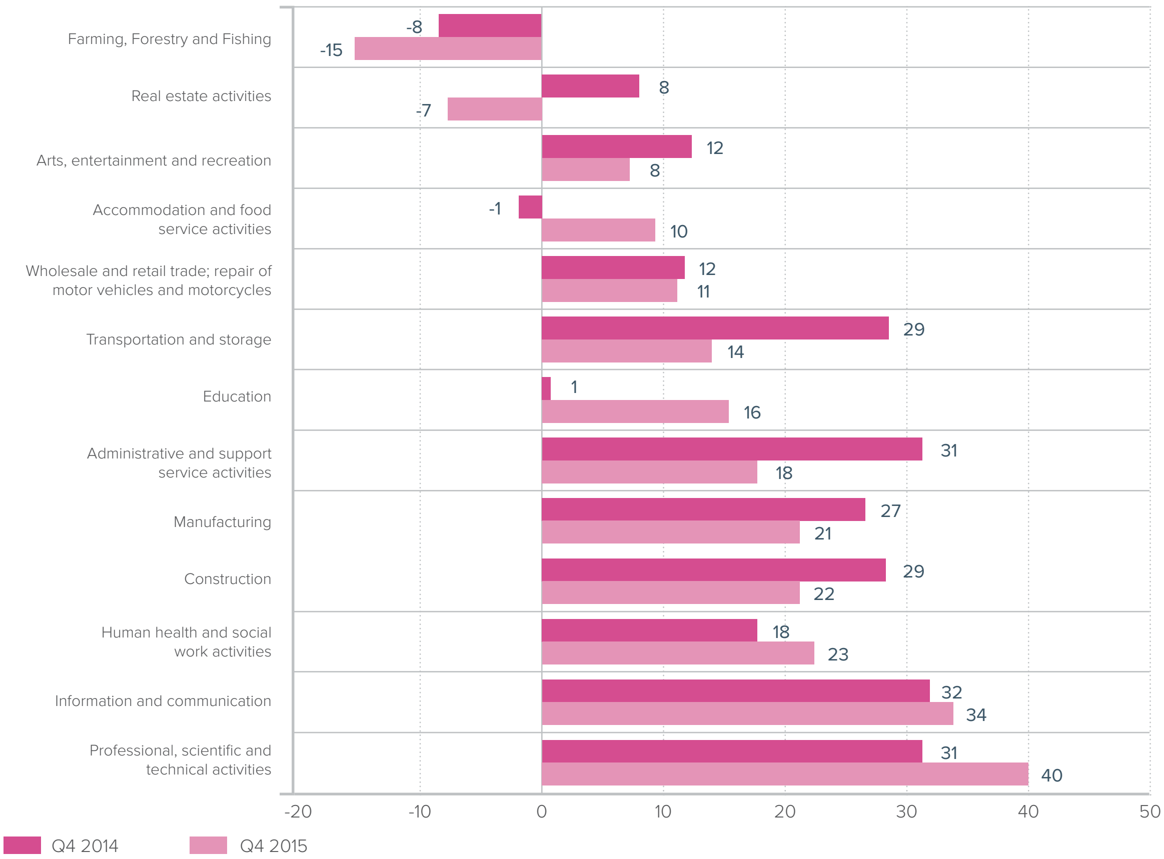



Figure 11:
FSB SBI by sector – small business prospects over coming three months

Source: FSB SBI/Annual Review Q4 2015. *Note: the classification of sectors uses the Standard Industrial Classification 2007 (SIC07) since Q1 2015. This changes the grouping such that some sectors have no exact equivalent from Q4 2014. As close matches as possible have been found for all sectors.

# REVENUE AND PROFITABILITY

Almost one in four firms (24%) report revenue growth in the last three months – the highest since 2010

# BUSINESS GROWTH REMAINED BUOYANT AS 2015 DREW TO A CLOSE

This quarter, the net balance of small firms reporting that their revenues grew over the past three months stood at almost one in four (24%). This is the joint highest since the series began in 2010, reflecting the robust business confidence levels currently prevailing. Firms expect a similar level of growth over the next quarter as well, in line with the high share of companies that are projecting business conditions to remain about the same ahead.

Along with rising revenues, a solid net balance of 15% of small firms report that their profitability rose this quarter, marking almost two full years of continuous profit growth. As well as higher turnover, this performance is likely to have been partly boosted by falling prices in many global commodities and gas prices, and effectively flat electricity prices compared to a year ago.

Positive expectations for these key financial metrics are good news for the start of 2016. The overall economy slowed through 2015 and is likely to continue to do so this year, on the back of continued government austerity and a weaker global economy. However, it's encouraging that the small private business sector is maintaining its momentum, which is a marked change from five years ago: From 2010 until mid-2013, a net balance of firms reporting that their turnover was falling quarter on quarter, and it wasn't until mid-2014 that profits started to rise in a sustainable fashion.

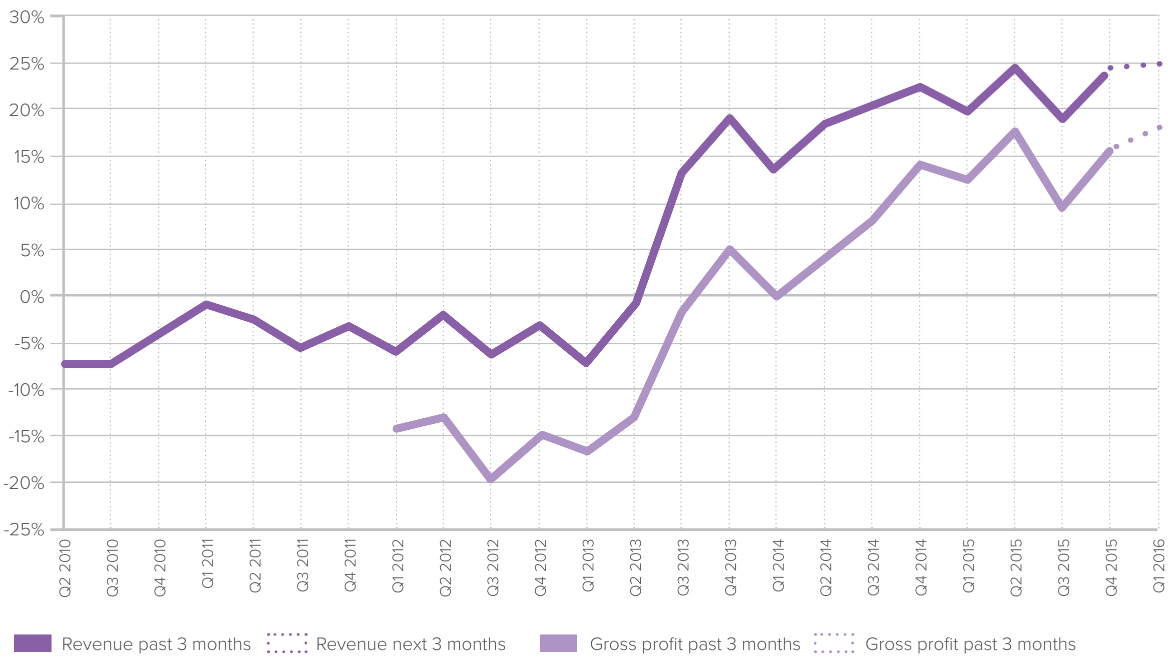



Figure 12:
Small business revenue growth and gross profit, net percentage balance – proportion reporting increase less proportion reporting decrease

Source: FSB SBI/Annual Review Q4 2015.

# EXPORTS

Nine per cent of small businesses report that revenue from their exports rose over the past three months

# SMALL BUSINESS EXPORTS GROWING DESPITE GLOBAL HEADWINDS

The latest global figures show that growth in world trade volumes has been slowing in recent months and actually fell back by 0.3% year on year in September, as China cools and the Eurozone remains fairly weak. Despite this backdrop, however, a positive net balance of 9% of small businesses report that revenues from their exports rose over the past three months. This result often tends to fluctuate from quarter-to-quarter, but the general theme is that small businesses are managing to increase their export potential. This is a notable difference from 2012, when the series began and when a net balance of firms report that their revenue from abroad was falling.

However, despite this growth among small exporters, there are still plenty (77%) that aren't able or don't want to sell their products or services overseas. For those that do export, almost half (47%) report that the main barrier to increasing their trade is fluctuating exchange rates. While this is a difficult aspect to get around, a third of firms (32%) report that difficulty finding customers is a key challenge when it comes to exporting – which is something that the Government aims to help with through trade missions and other support primarily through UKTI. Legal and regulatory requirements are a problem for 29% of small exporters, suggesting that further assistance could be given in this regard.

Exporting is one side of the trade balance; the other being imports. This quarter 22% of small firms report that they import goods or services, meaning that for most, doing business is a strictly domestic affair. However, for those that do purchase from abroad, the biggest challenge is again the fluctuating exchange rate, with 46% reporting this. Legal and regulatory requirements are another problem, with 18% pointing to this factor. Encouragingly though, a quarter of importers report that they face no barriers to purchasing from abroad.

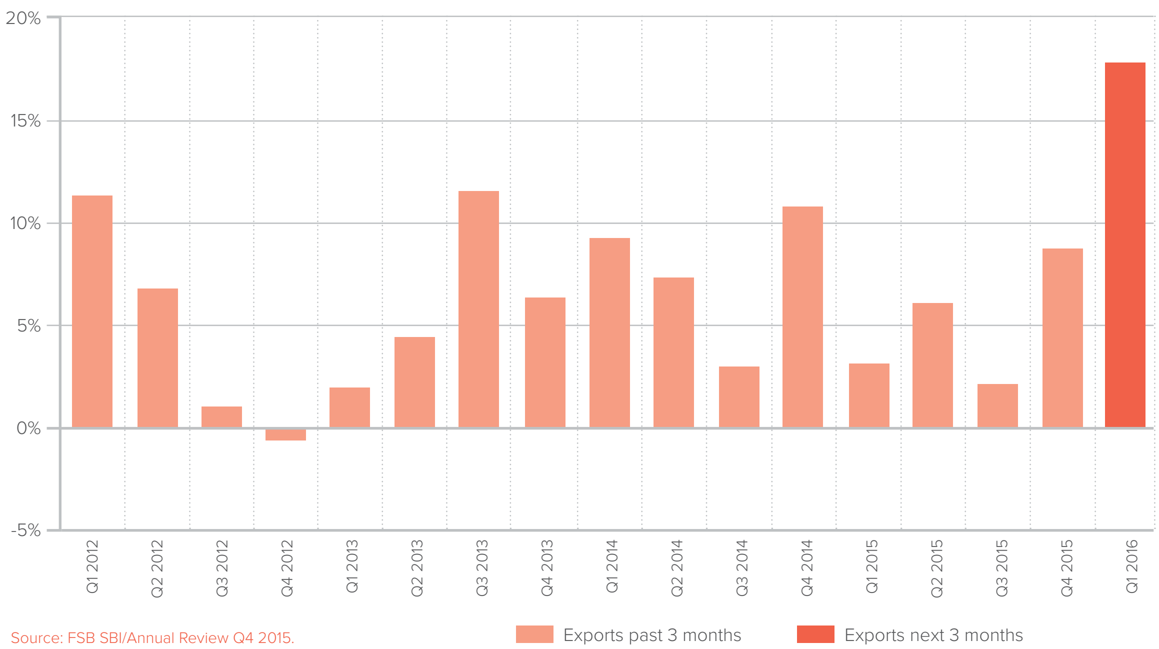



Figure 13: Changes in value of exports – previous three months and expectations for coming three months; net percentage balance, proportion reporting increase less proportion reporting decrease

Source: FSB SBI/Annual Review Q4 2015.

# COSTS AND INFLATION

52 per cent reported an increase in costs– the first time over the half-mark since the end of 2014

# COSTS ARE STARTING TO RISE AGAIN, BUT INFLATION REMAINS LOW FOR NOW

As highlighted at the start of this report, an almost unique feature of 2015 in UK history was the fact that headline inflation stood at zero for the majority of the year. While the consumer price index is the inflationary measure that grabs the most headlines, 2015 also saw inflation on the business-to-business prices charged by service firms slowing towards zero, and standing at around zero for manufacturers (excluding volatiles like food and petrol).

This same trend has been evident in the figures from the SBI survey, as illustrated in the figure below. In Q1 2015, just 44% of firms reported that their operating costs had increased over the past three months, the lowest result since the series began in 2011. However, over the last few quarters, the share of firms reporting rising costs has been on the up. In Q4 2015, 52% reported an increase – the first time over the half-mark since the end of 2014.

The reason for this recent upward trend appears to be due to rising labour and rent costs rather than a change in the outlook for global commodities. Indeed, just 12% of firms report fuel as a key driver of cost growth this quarter, down from 22% at the same point a year before and 47% in 2013. Similar trends can be seen in the figure below for utilities and physical inputs. On the other hand, 45% of firms state that labour is a contributor to costs this quarter, up from 36% two years ago. This trend is likely to continue as the labour market tightens, with the unemployment rate already down to pre-crisis levels. Office vacancy rates in city centres have also been on a downward slope in recent months, reflecting supply constraints for commercial property: with rental growth accelerating in most of the UK's key cities, adding extra pressure to cost growth. This quarter, 20% of firms report rent as a key driver of their costs, up from 16% at the same point in 2013.

Over the next couple of years, inflation from physical inputs is likely to be relatively weak, as oil prices remain much lower than in mid-2014. Cost growth from less tradeable inputs like labour and rent are expected to continue rising though, and as such, business input costs are likely to start growing at a faster rate than in 2015.

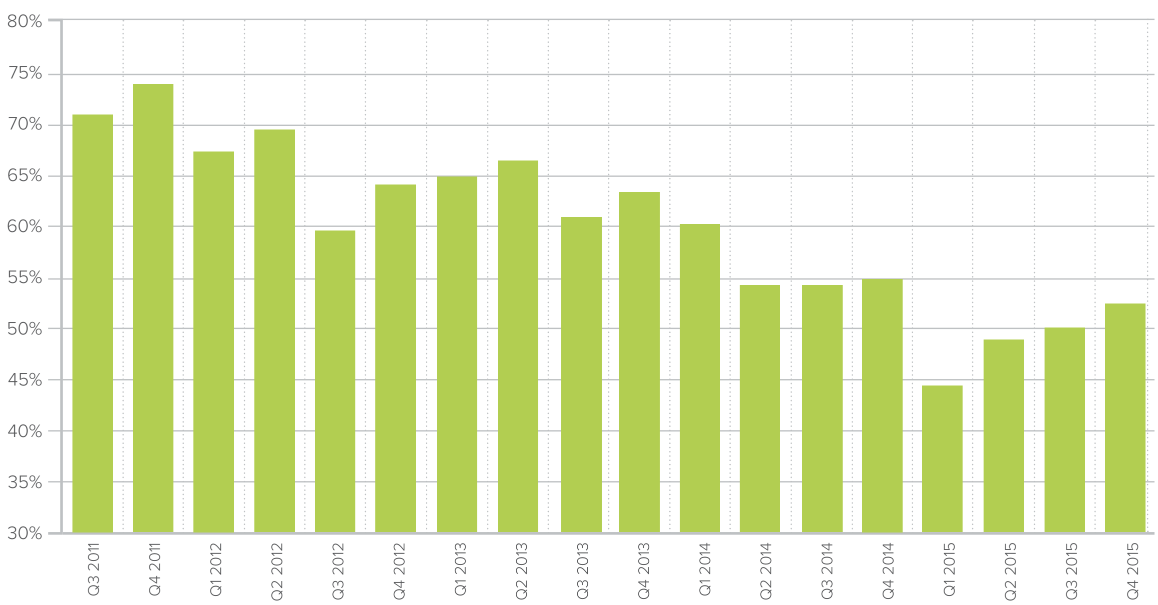
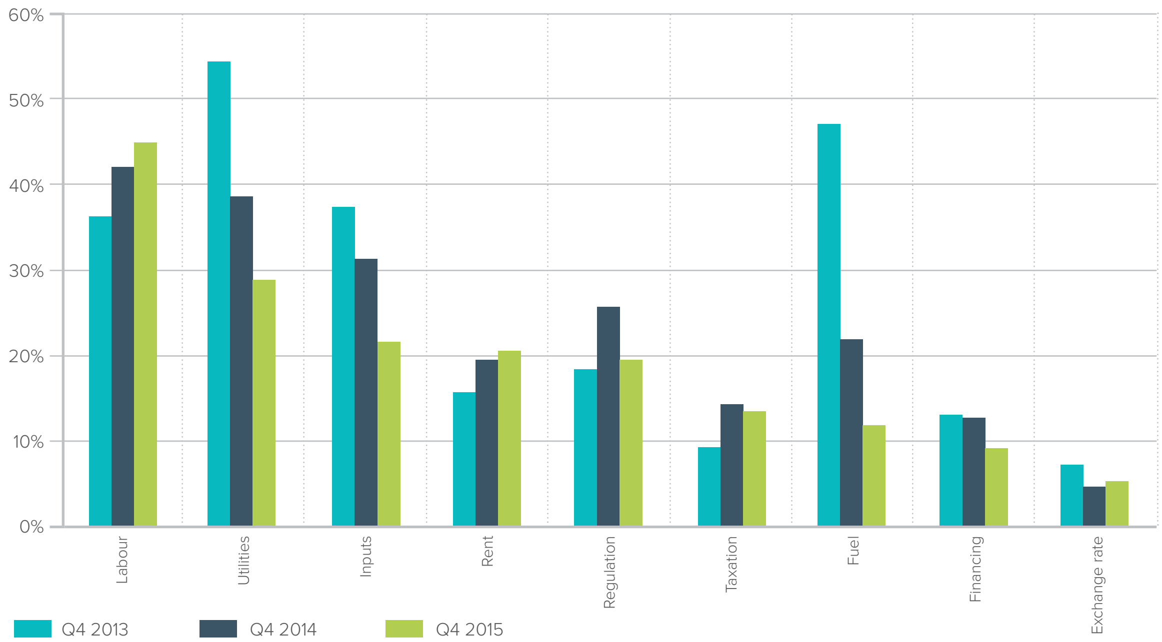



Figure 14:
Small businesses reporting an increase in overall cost of operation over past three months; net percentage balance

Source: FSB SBI/Annual Review Q4 2015.




Source: FSB SBI/Annual Review Q4 2015.

Figure 15:
Main causes for changing business costs (firms may give multiple answers)

# CAPACITY

36% of firms expect to have spare capacity in their business over the next three months

# SPARE CAPACITY CONTINUES TO FALL BACK

This quarter, a net balance of just 38% of small firms report that they are operating with spare capacity, following a general downward trend over the past few years. At the same point a year ago, 46% of firms were below capacity, and through much of 2010 to 2012, almost 60% were reporting the same.

Although this series began in 2010, so pre financial crisis figures are not available for comparison, it is certainly the case that slack in the UK economy has shrunk significantly during the last half decade, suggesting that the need for a base rate rise is getting closer. The Bank of England in their November Monetary Policy Committee meeting noted that growth in the economy is likely to be sufficient to eliminate all remaining spare capacity during 2016, and commentary from Governor Mark Carney points to the first rate rise happening towards the end of the year. The SBI findings back up this Bank of England projection, as only 36% of firms expect to have slack in their business over the next three months. If realised, this would be the lowest level of spare capacity since the series began.

Looking beyond the headline findings, the industry breakdown for spare capacity reflects the business confidence findings described earlier in the report. In the business services sector, a net balance of just 22% report operating with slack, and 32% in the information and communication industry. This compares to 54% in the accommodation sector, where skills shortages are less apparent.

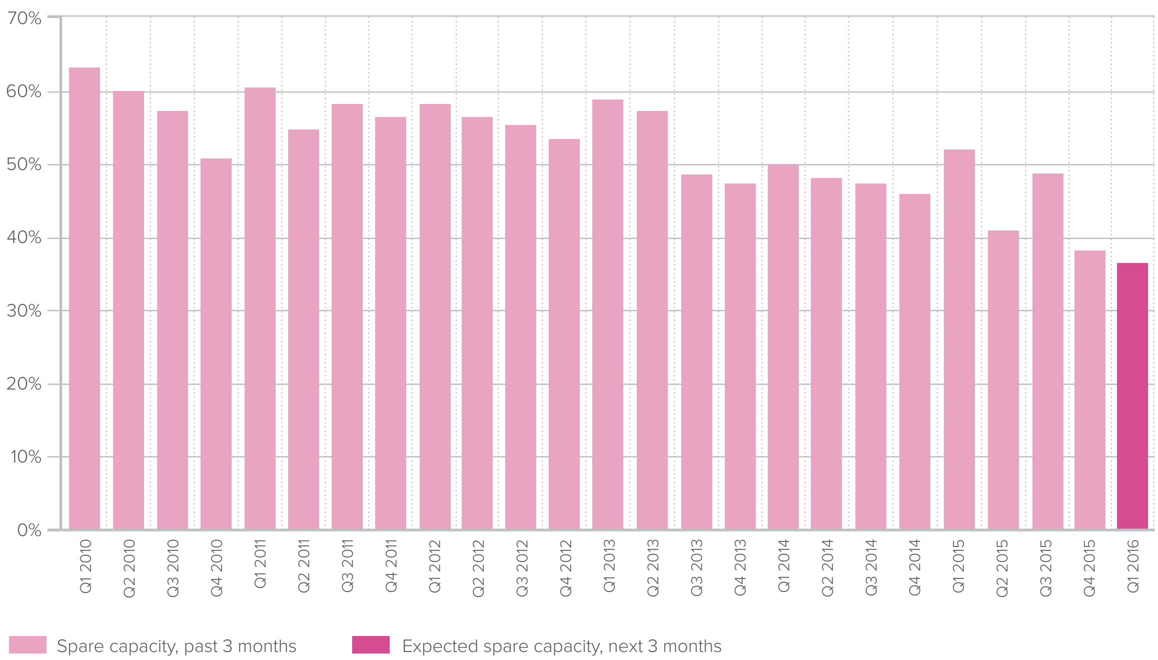



Figure 16: Net percentage balance of businesses running below capacity: proportion below capacity less proportion above capacity

Source: FSB SBI/Annual Review Q4 2015.

# EMPLOYMENT AND WAGES

A net balance of 6.7% of small firms reported that they expanded their staffing levels, up on the previous three months and the same point a year before

# JOB CREATION REMAINS ROBUST AMONG SMALL FIRMS

As discussed earlier in this report, the rate of unemployment in the UK dropped to 5.3% in Q3 2015, broadly in line with levels seen before the financial crisis. Annual employment growth in the total economy has slowed in recent months however, to 1.4% in Q3 2015, down from close to 3% in 2014. This slowdown in hiring appears to be coming predominantly from large firms, as small businesses continue to increase their headcounts. As illustrated in the figure below, this quarter a net balance of 6.7% of small firms reported that they increased their staffing levels on the previous three months and the same point a year before.

This quarter's result is the latest in two and a half years of steady employment growth among small firms, and stands in direct contrast with the periods before that. Between the beginning of 2010, when the series started, and the middle of 2013, small companies on average reported that they were contracting their headcounts every quarter, providing a significant dampening effect on labour market conditions. Encouragingly, small business owners expect to continue their run of creating jobs, with a net balance of 7.3% planning to hire more over the coming three months. This is very positive news, as small businesses (i.e. those with up to 50 staff) account for roughly half of all employment in the UK, and so will continue to provide job opportunities at a time when the public sector is cutting back.

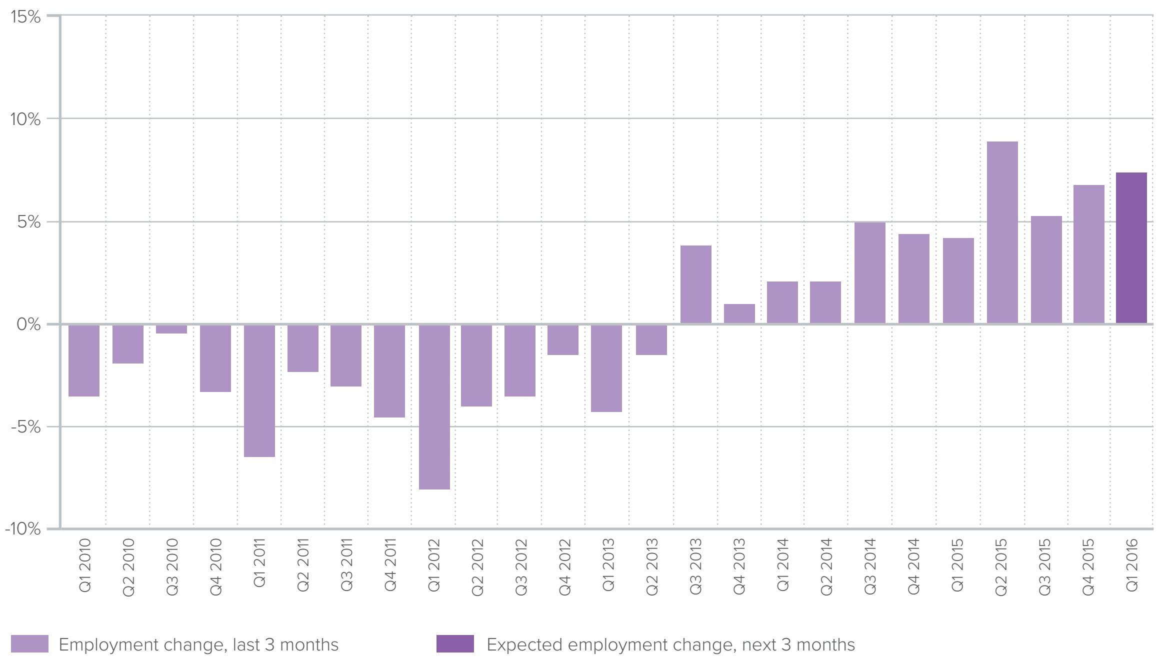



Figure 17:
Net percentage balance change in number of people employed – proportion reporting increase less proportion reporting decrease

Source: FSB SBI/Annual Review Q4 2015.

# WAGE GROWTH CONTINUES TO ACCELERATE AS INFLATION STANDS AT ZERO

Average pay growth has been picking up across the economy in recent quarters according to figures from the ONS, and the small business sector is no exception to this. Results suggest that salaries increased on average over the past year by 2.3%, the fastest since this series began in 2014 and up from 1.9% in the previous quarter. Although data are unavailable for most of the past five years on this measure, whole-economy figures indicate that pay conditions for workers have recently improved, following a period of sluggish growth since 2009. This is particularly good news at the moment: with inflation standing near zero, all of this increase in nominal terms is passed through into increased spending power, helping to support the UK economy.

Within the headline results, the wholesale and retail sector has been awarding some of the smallest pay increases over the past year, with an average of 2.0% among small businesses. This likely reflects the current difficult nature of business conditions in the sector, as well as no particular shortage of skills. This compares to 3% in the construction sector, where finding people with the right experience has become more of a challenge.

Looking ahead, the next 12 months are projected to remain buoyant for wage packets at small businesses. On average, firms expect to increase salaries by 2.7%. Although inflation is expected to increase in 2016, eroding some of this growth in real terms, pay is expected to rise in real terms, in the coming months more than during the previous quarter.

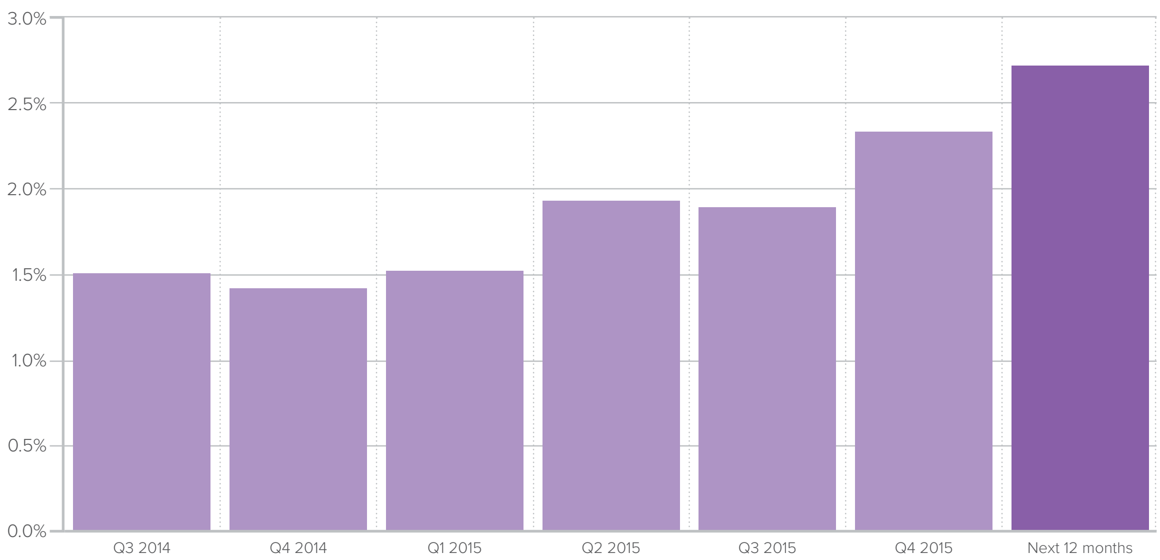



Figure 18:
Average salary increase awarded, this quarter versus a year before

Source: FSB SBI/Annual Review Q4 2015.

# PRODUCTIVITY

Productivity in small firms reached three per cent up from 2.6 per cent in the previous quarter and 1.5 per cent a year ago

# PRODUCTIVITY GROWTH CONTINUES TO ACCELERATE

This quarter, annual growth in productivity among small businesses (measured by output per worker in real terms) picked up again, reaching 3%. This is up from 2.6% the previous quarter and from 1.5% at the same point a year ago. This latest positive movement comes on the back of solid growth in turnover, but is also helped significantly by the low inflation environment. With overall price growth in the economy at near-zero levels, increases in revenue in nominal terms also mean notable growth in real terms. This means that as the rate of inflation picks up in 2016, productivity growth is likely to be constrained to some extent.

The latest results from the ONS show output per worker across the economy as a whole rising year on year by 1.1% in Q2 2015. This compares to 2.6% for the same time period on the FSB small business measure: small firms are making stronger productivity gains than other parts of the economy. For additional comparison, labour productivity in the manufacturing sector fell back by 1.8% year on year in Q2 2015, indicating particularly weak business conditions.

The latest small business result is the sixth consecutive quarter of rising productivity, and comes following three and a half years of productivity falling back year on year. This is a very positive development for the UK economy, as small businesses are helping to produce more for the same amount of input, either through greater usage of capital equipment, having better trained staff, or becoming generally more efficient.

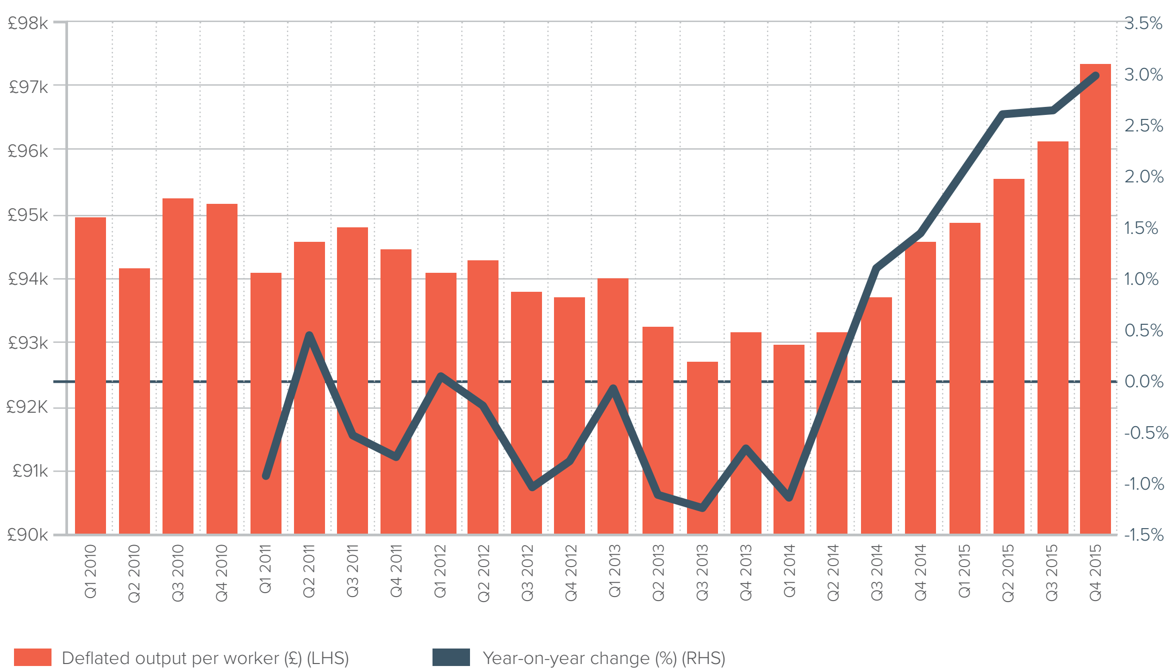



Figure 19: Small business productivity and year-on-year change (inflation-adjusted turnover per employee)

Source: FSB SBI/Annual Review Q4 2015.

# GROWTH ASPIRATIONS AND CHALLENGES

A growing proportion of companies expect to be about the same size in 12 months' time

# MORE FIRMS ANTICIPATING A 'STEADY AS SHE GOES' YEAR AHEAD

This quarter, the share of businesses anticipating that they will 'grow rapidly or moderately' stood broadly unchanged, at 59.3% compared to 58.7% in Q3 2015. However, in line with the rising share of firms that expect business conditions to remain stable rather than worsen or improve, there is a growing proportion of companies that expect to be about the same size in 12 months' time. This figure has risen to roughly a third this quarter (32%), from a low of 27% in Q2 2015.

Despite these recent changes, the latest results compare favourably with those seen since the beginning of 2012, when these results were collected for the first time. This can be seen in the chart below, where back in Q2 2012, just 52% of firms expected to grow over the next year, and 64% expected to remain about the same size.

In addition, a further encouraging sign of business prospects is that the share of firms expecting to close in the next year has fallen to just 1.2% this quarter, down from 2.7% in Q3. In fact, this is the smallest proportion since the series began at the start of 2012, and compares to an average over the whole time period of 3.4%.

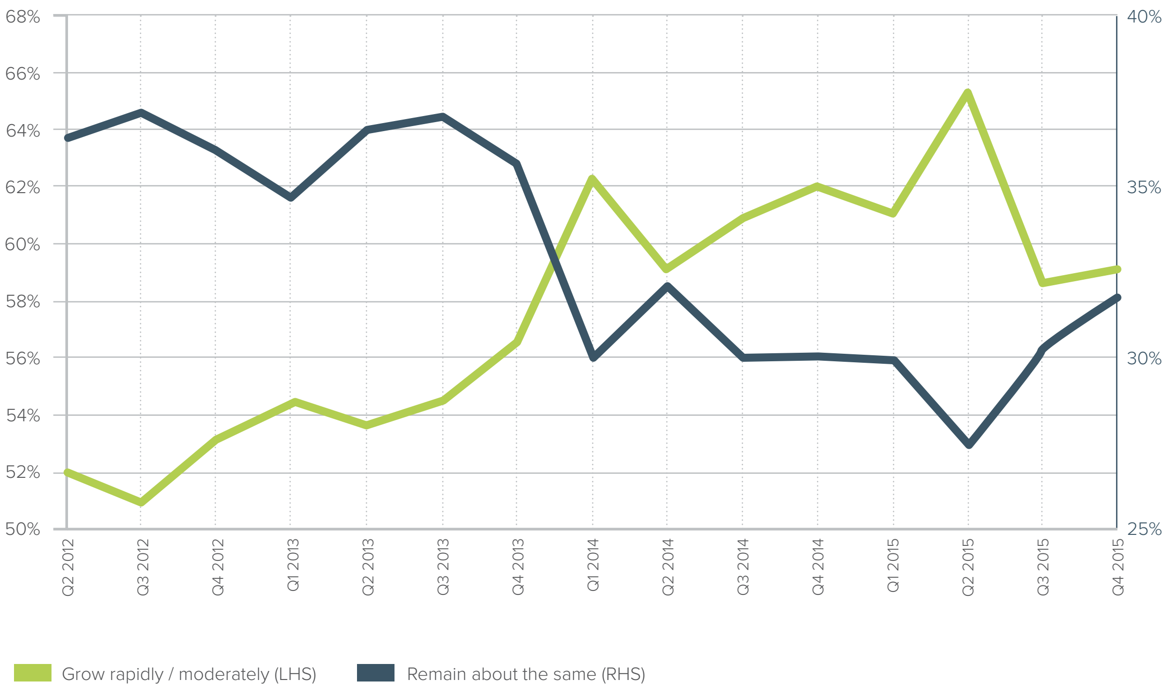



Figure 20:
Share of firms expecting to grow, or remain about the same over the next 12 months

Source: FSB SBI/Annual Review Q4 2015.

# STAFFING CONCERNS BECOMING MORE PRESSING

This quarter, the primary barrier to achieving growth aspirations remained the domestic economy, cited by 46% of firms, up from 36% at the same point a year ago. In second place was consumer demand – however, this factor has fallen considerably over the past 12 months as a potential barrier to growth. This comes alongside the sharp boost to households spending power from the persistent 'no-flation' climate that has emerged in 2015, suggesting that consumers are using this windfall to increase their spending habits.

The next largest concerns are both staff-related. A third of businesses (33%) report that finding appropriately skilled staff is one of their greatest barriers to growth, significantly up from just 12% reporting the same in Q4 2014. Likewise, labour costs have risen as a concern, to 30% of firms this quarter from 8% at the same point last year. Both of these factors are worsening at the same time as the labour market is tightening – as joblessness falls, it becomes harder to recruit the workers that businesses need, and it's more likely that these workers will need to be paid more to stay on.

Of least concern to businesses this quarter are the costs of fuel, utilities, other physical inputs and financing. These have all fallen back as a key threat to growth over the past 12 months, as the cost of global commodities has diminished.

These trends seen over the past 12 months are something of a continuation of those seen over the past five years. The cost of physical and energy inputs has been falling steadily back, the labour market has been tightening over the whole timeframe, but the state of the domestic economy has generally been of paramount concern to small businesses.

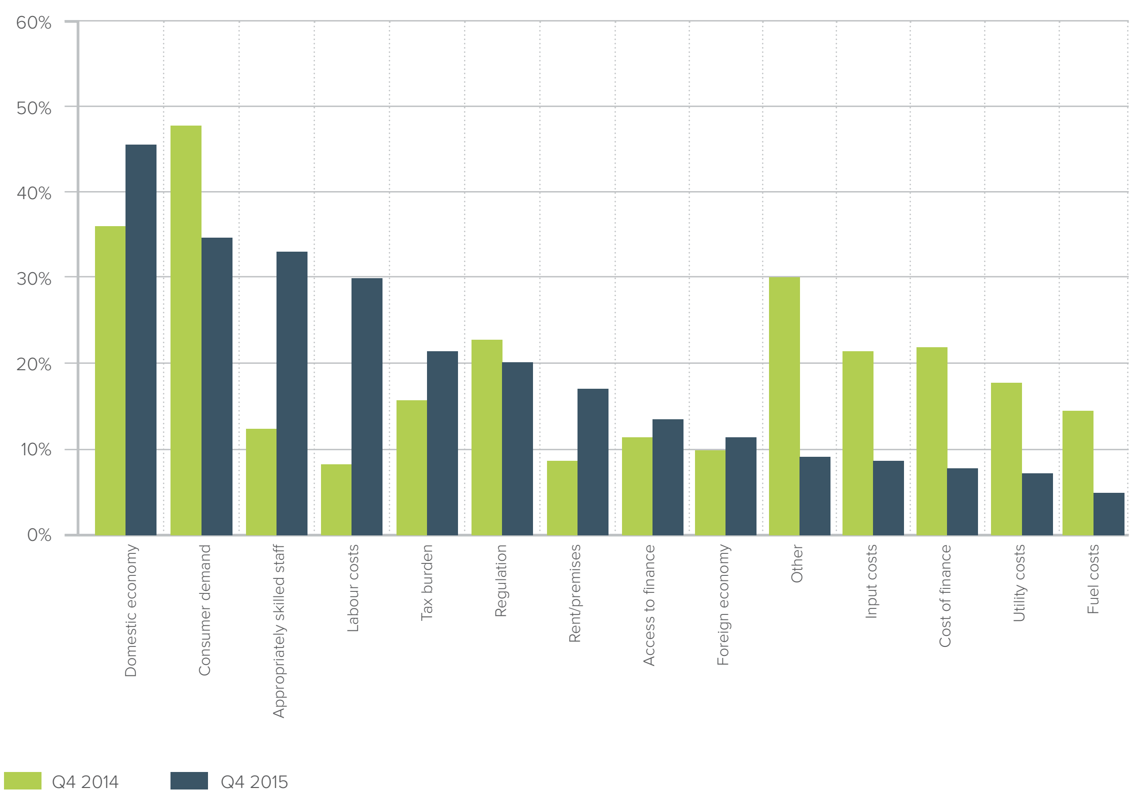



Figure 21: Potential barriers to achieving growth aspirations – multiple answers possible

Source: FSB SBI/Annual Review Q4 2015.

# CREDIT

More than half (57%) this quarter had their loan approved, compared to 45% in 2012

# CREDIT

Figure 22:
Credit applications and interest rates offered

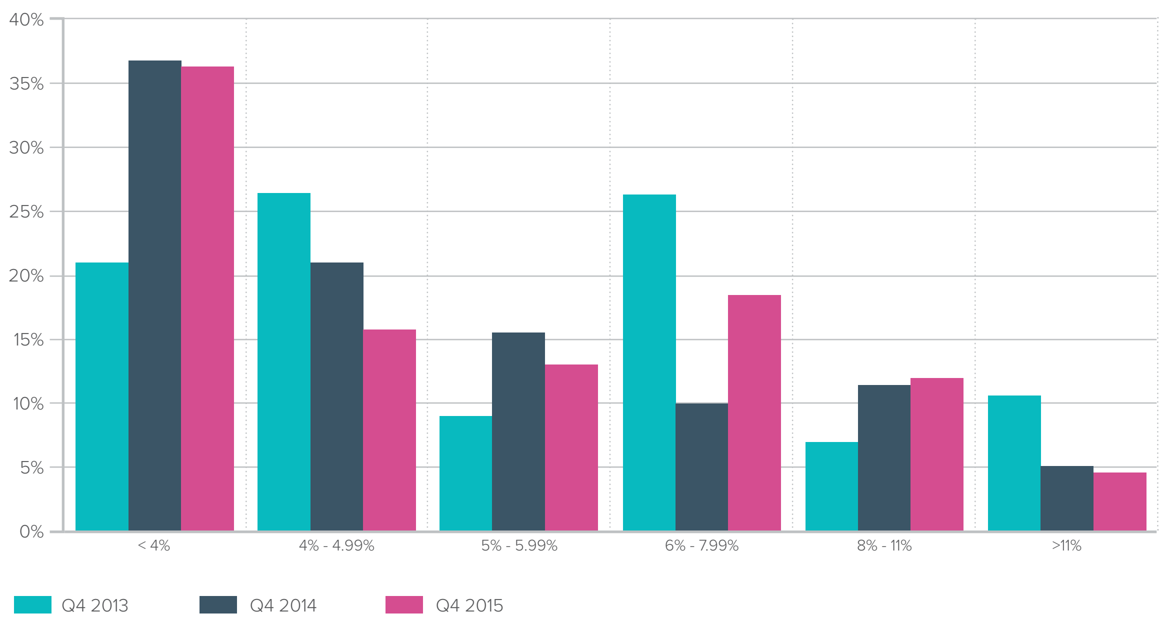
Have you applied for credit in the past three months?

No – 87% | Yes – 13%

Were you successful?

No – 33% | Yes – 57% | Decision pending – 10%

What rate were you offered?




Source: FSB SBI/Annual Review Q4 2015.

The share of small businesses applying for credit has been steadily falling back over the few years. In Q1 2012, when this series began, just over one in five firms had made a credit application in the past three months. This figure has generally fallen back since then and stands at just 13% in the latest results. Alongside this trend, a rising share of applicants has been successful in their bid. More than half (57%) this quarter had their loan approved, compared to 45% in 2012. This suggests that either it is becoming easier across the board to get access to finance, or the firms with the weakest financial prospects have stopped applying for credit.

It is currently the largest of small firms that are most likely to make an application, with 17% of those with between 21 and 50 staff doing so, compared to 13% for those with up to 10 staff and just 6% for those with no employees.

The average rates offered to businesses has also been declining. Two years ago, in Q4 2013, just 21% of loans were offered with a rate of 4% or less, and 11% of loans were offered with an interest rate of 11% or more. Since then, the share of loans with the lowest interest rates has climbed notably, and fallen for those with the highest rates, as illustrated in the figure above.

New figures this quarter suggest that the majority of credit is used simply to manage cash flow: 60% of firms reported that this was how they used the finance available to them. A further 13% used the cash for maintenance purposes, by updating their old equipment. Just 18% of firms used their lines of credit to actually expand their business. These reasons for requiring funds are also reflected in the types of financial products chosen. Of those that applied for credit, 64% used an overdraft and a further 14% choose invoice financing. Only around a third of credit (37%) was taken out as a loan. Although it's still a new field, roughly one in twenty firms applying for finance chose to look for peer-to-peer lending. This remains a small figure for now, but is likely to grow quickly over the coming years.

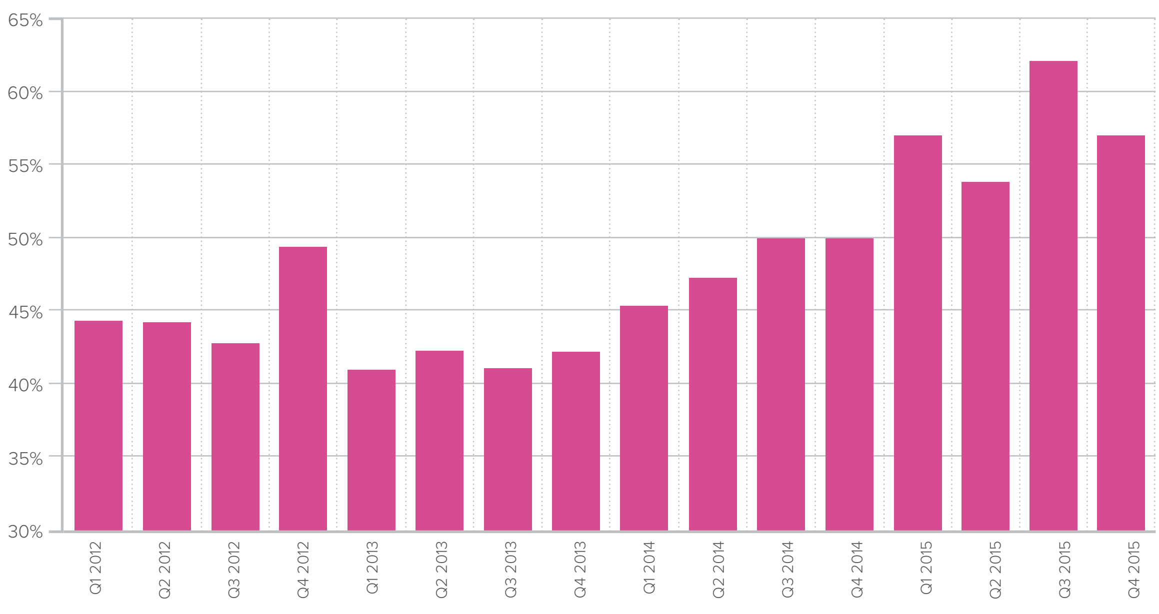



Figure 23: Proportion of small businesses successful in bank credit (e.g. loan or overdraft) applications in the past three months

Source: FSB SBI/Annual Review Q4 2015.

# CREDIT AFFORDABILITY AND AVAILABILITY HAVE IMPROVED NOTABLY OVER THE PAST FEW YEARS

Although this quarter the Credit Availability and Credit Affordability indices (as illustrated in the figure below) have dropped back slightly, both are notably up on the same point a year ago, and have generally improved since the start of 2012. In the latest results, almost one in four (23.3%) report that they find credit to be affordable, up from 18.1% at the same point in 2014, and from just 13.1% at the beginning of 2012. Likewise, 18.2% of businesses report that credit is generally available, up from a year before and from half that figure in 2012.

These results tie in with the earlier section on barriers to achieving growth aspirations – where the cost of finance is notably down as a key concern, and also as a driver of the cost of business operations. However, although the trend over the past few years reflects a stabilising economy and a recovering financial system after the crisis and recession of 2008-09, affordability could worsen in the next few years. The Bank of England is expected to start raising its base rate at some point in 2016, which will likely be passed on to the cost of financing that small firms face. As such, borrowing for investment or to ease cash flow will become more of a difficult decision, and more businesses will start to feel the pressure on their bottom lines.

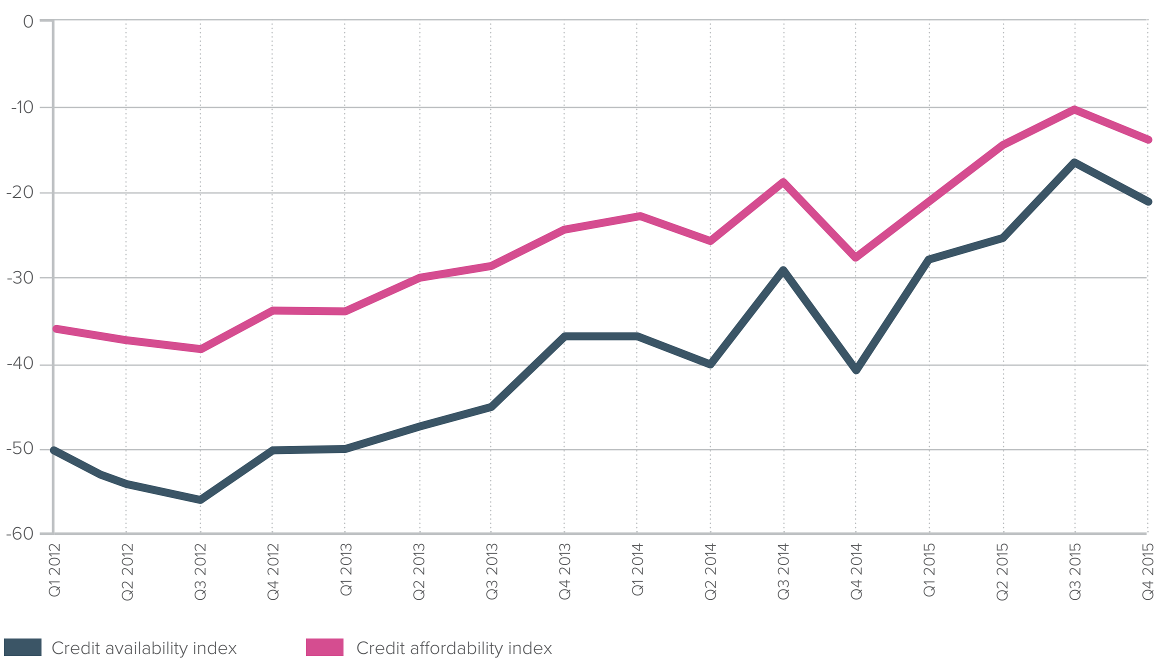



Figure 24: Indices of credit affordability / availability perceptions over time, a weighted net balance of those with negative responses subtracted from those with positive responses

Source: FSB SBI/Annual Review Q4 2015.

# INVESTMENT

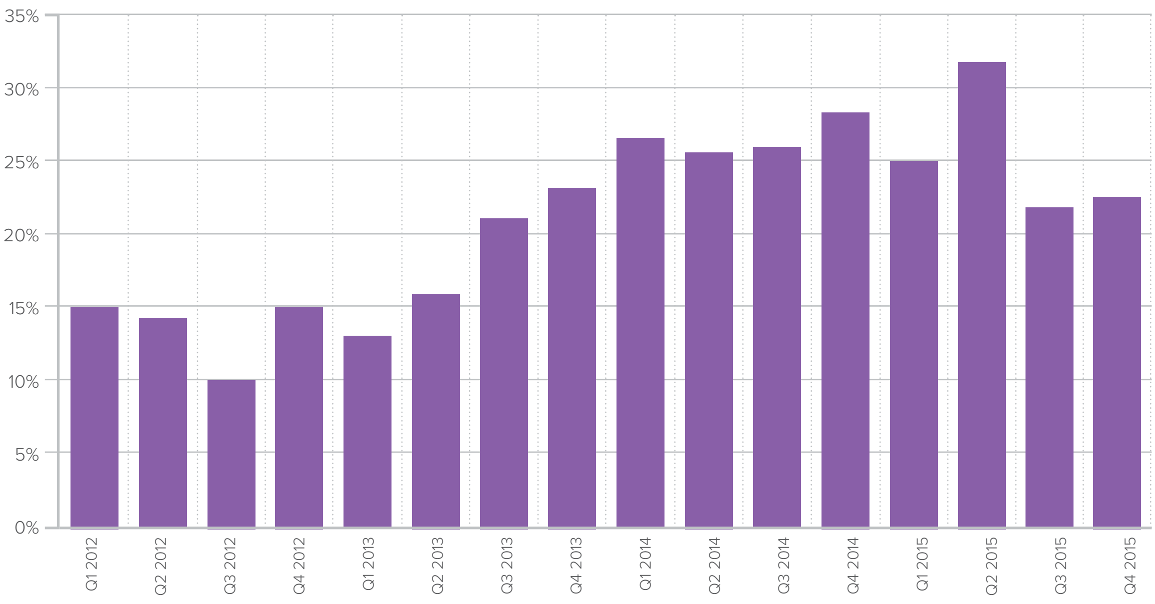
A balance of 22 per cent of firms anticipate increasing capital investment during the next year, down from 2014

# INVESTMENT INTENTIONS HOLDING STEADY

Although overall small business confidence has held generally firm this quarter, it remains weaker than the highs seen in 2014. This same change of sentiment is apparent in the investment intentions illustrated in the figure below. This quarter, a net balance of 22% of firms anticipates increasing capital investment during the next year, down from the highs of closer to over 25% across 2014 as a whole.

It is good news that a positive balance of firms wish to invest in the coming months, and that are more plan to do so than during 2012, when this series began. However, it is slightly discouraging for UK growth prospects that small businesses are cooling their investment intentions. Capital expenditure is often a key driver of increases in labour productivity, which as described earlier remains slightly fragile.

Within the headline results, more firms in the manufacturing sector are expecting to boost capital spending than across the UK as a whole, with a net balance of 28% expecting to invest. This compares to just 16% among small companies in the retail and wholesale sector. These sectors are likely to be particularly affected by the introduction of the National Living Wage in 2016, and as such could be expected to try to counteract this by making additional capital investments – however, this does not seem to be the case.




Source: FSB SBI/Annual Review Q4 2015.

Figure 25:
Net percentage balance in anticipated capital investment growth over next 12 months – proportion reporting increase less proportion reporting decrease

# THE YEAR IN REVIEW

## FSB policy research

# BUSINESS RATES RESEARCH

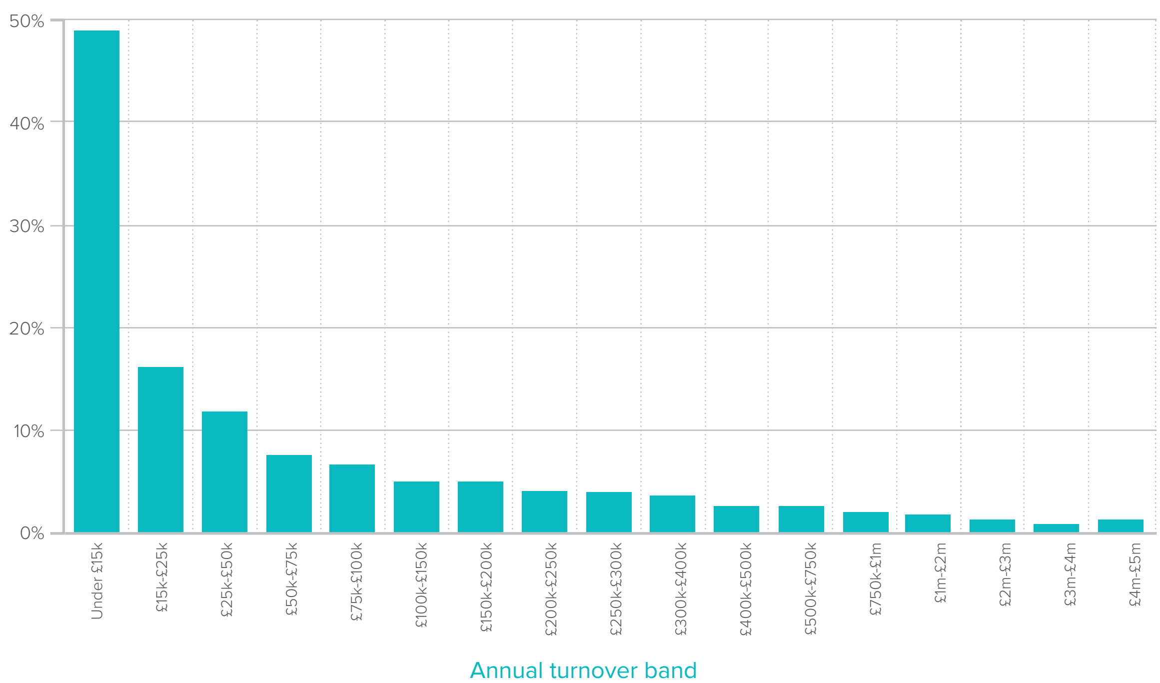
The business rates system continues to have a significant impact on smaller firms. Business rates are now fully devolved to Scotland, Wales and Northern Ireland, and under full devolution, all three devolved administrations will be able to determine their own business rates system including setting tax rates.

Across the nations and regions of the UK, and whether devolved or retained by Westminster, the current business rates system has lost the support of the business community. It is complicated, opaque, regressive and unresponsive to changes in economic conditions.

In the short term, FSB has succeeded in convincing the Chancellor to extend the temporary doubling of small business rate relief for another year. This benefits over 600,000 of the most vulnerable small firms. FSB has also been conducting research into more fundamental long-term reforms and have presented costed options to the Government.

Using the FSB's membership database and robust economic analysis, FSB and Cebr have demonstrated that the current system of basing tax liabilities on rateable values has a particularly harsh effect on micro firms and start-ups.

RV as a share of turnover




Source: FSB SBI/Annual Review Q4 2015.

We have also used this analysis to test and evidence our proposals for reform. We have demonstrated that:

1. The Government could remove 1.2 million of the smallest properties from non-domestic rating altogether in a revenue-neutral manner for just an additional 4p on the multiplier.
2. The Government could improve Small Business Rate Relief by reforming it into a small firms property allowance similar in operation to the personal tax allowance. If an allowance of £8,000 of rateable value was granted to all small firms with a total rateable value of less than £18,000, this would remove the disincentive to expand caused by the loss of small business rate relief that occurs after a year of having occupied a second property.
3. The Government could be radical and tax small firms based on their turnover rather than their occupation of property to ensure that tax contributions are closely aligned to economic conditions. A tax rate of 1% on all firms turning over £260,000 or less would raise the £3 billion required to remove all hereditaments with a rateable value of less than £18,000 from non-domestic rates liabilities.

FSB will judge the outcome of the Government's ongoing administrative and structural reviews on whether their combined effect delivers arrangements that are fairer, more flexible, more responsive to economic conditions, and more transparent than currently provided. There is a clear need to introduce modernisation into the administration of the system, with particular reference to billing and data collection.

We also want to see greater transparency for ratepayers on how valuations are derived and the evidence used by the Valuation Office Agency (VOA) to arrive at its assessments. This would be of clear benefit to both improving the efficiency of the business rates scheme as well as reducing the burdens being placed on small firms.

In addition, provisions in the Enterprise Bill around reforming the appeals system are critical. Both the Government and businesses recognise that the current arrangements for appeals are unsustainable, with around 70% of appeals resulting in no change. FSB believes that the new appeals system must maintain fairness to business rate payers, not simply seek to reduce appeals by making it more difficult to appeal.

# TAX RESEARCH

Smaller businesses report they want the Government to simplify the tax system and that this needs to be a top priority. FSB's SBI Q4 results show that just over a fifth (22%) of businesses believe the tax burden is a potential barrier to achieving growth ambitions, a higher level than in 2014 (16%).

While the Government provides a number of tax incentives and relief schemes many smaller businesses reported they were not aware of different programmes. Of businesses surveyed about their awareness of different tax reliefs a third (32%) were not aware of this relief and over two thirds (68%) were not aware of rural rate relief.

In April 2013, the Government introduced cash basis accounting to make it easier for sole traders and partners to comply with their tax requirements. Half (51%) of the smaller businesses surveyed used cash basis accounting and for a majority of these the experience was positive (54%).

The Government has bought in new measures to rebalance the tax system, increase tax revenue and tackle avoidance and evasion. At the 2015 Summer Budget it was confirmed that from April 2016, the dividend tax credit would be replaced with a tax-free allowance of £5,000 of dividend income for all taxpayers and a new set of tax rates on dividends over £5,000. This change to the tax treatment of dividends will affect around half (47%) of the businesses surveyed.

Businesses reported that they took dividends rather than a salary for earnings of up to 25% (22%), up to 50% of earnings (20%), up to 75% of earnings (29%), and over 75% of earnings (29%). Over a third of businesses (35%) have said they will take income out in other ways to reduce tax liability, whereas others (10%) do not plan to take any action. Some intend to increase prices to maintain net income (8%) or to reduce staff (6%). A small number of businesses (2%) said they will close.

The majority (73%) of the businesses surveyed are registered for VAT. The survey shows that VAT thresholds can affect the competiveness of a business, and opinion is divided on where the threshold should sit. The VAT threshold is set at £82,000, and 40 per cent want this increased, 28 per cent say it should stay the same, 24 per cent want the threshold removed so all business must be VAT registered, and 5 per cent say it should be lowered.

The tax system is complex and time consuming:

- The most complex taxes to deal with are VAT (27%), Corporation Tax (21%), Income Tax (18%) and PAYE (15%).
- It was common practice for businesses (78%) to seek external help with tax calculations and the vast majority of businesses (95%) favoured their accountant, tax advisor, or bookkeeper. HMRC's online, telephone, or face to face services were also popular with over a third of businesses (37%).
- Most businesses (71%) spend up to a day a month on their tax forms. VAT was by far the most time consuming tax (47%), followed by PAYE (16%), Income Tax (16%), and Corporation Tax (16%). A large number of small businesses do their own VAT returns with under a third (29%) paying an external accountant, payroll team, or tax advisor.

The combination of these features leave small businesses at a greater risk of non-compliance and/or being out of pocket. Around a third of businesses (32%) reported they had been late with their tax payments and the most common reason reported (52%) was cash flow problems. The cost of complying with tax obligations each year ranged from nothing (3%) to more than £25,000 (3%). Costs of £1,001 to £5,000 were most common (42%).

The Office of Tax Simplification (OTS) is undertaking a review of the taxes that smaller businesses pay. The aim is to make the tax system easier for smaller businesses to comply with. The OTS will provide an initial report to the Chancellor by the 2016 Budget that:

- examines evidence and identifies the areas of the tax system that cause the most day-to-day complexity and uncertainty for small incorporated businesses
- recommends priority areas for simplification
- considers the impact of any simplification in these areas on other business sectors, particularly small unincorporated businesses

FSB is working with the OTS and pushing for a tax system for smaller businesses that resolves their tax issues and supports all the stages of the business lifecycle.

# TELECOMS RESEARCH

FSB carried out research into the experiences of smaller businesses interacting with the telecoms market, uncovering positive evidence showing the benefits that many small businesses were already experiencing through increasing their use of broadband and mobile services.

There is a clear benefit to the wider UK economy if small businesses were to further increase their use of these products. Small businesses who embrace the digital economy are more productive and more likely to grow.

FSB research found that large numbers of smaller businesses use the internet to communicate with suppliers, customers, employees, their bank and the Government. Being online allows many small businesses to sell goods and services in markets they would otherwise not be able to access, and for consumers across the world to search them out. Smaller businesses also increasingly see the internet as enabling them to use video content, cloud based services and remote work.

The potential benefits to small businesses of moving services online fell within the following categories:

- **Reassurance:** For some businesses, the key benefit is simply having a new and reliable way of connecting to customers, suppliers and employees.
- **Optimisation:** For others it is the time and cost-savings an internet connection can bring to business operations.
- **Transformation:** For the most digitally advanced businesses, being online provides a springboard to do new and different things in a way that helps the business expand.

Small businesses did however report that there remain several barriers which are stopping them from making full use of digital technology. The three main barriers stopping small businesses from doing more online were:

- **Satisfaction with the status quo:** Some small businesses were unable to effectively assess their own telecoms requirements, or to understand how digital technology could benefit their business. This led to underinvestment in digital technology. If small businesses were able to effectively assess what the direct financial benefits to their business would be, they would be far more willing to invest time and financial resources to engaging more with digital technologies.
- **Quality of service issues affecting small businesses as consumers:** There were a range of issues affecting small businesses as consumers of telecoms products. Very few small businesses employ an IT manager, meaning they have to rely on their own – frequently limited – understanding of a fast paced and complicated telecoms market. Small businesses wanted to avoid making potentially expensive mistakes, so did not engage as fully in the telecoms market as they could. Long delays in fault repair, the installation of new services and complicated contracts can also stop small businesses fully embracing digital technology.
- **Infrastructure availability:** There is widespread dissatisfaction with the availability of superfast broadband. Ofcom have found a gap in infrastructure availability between the residential and small business markets. According to Ofcom's 2015 Infrastructure Report, only 68 per cent of small businesses (excluding sole traders) have access to superfast broadband, compared to 83 per cent of the residential market.

Other issues can also affect small businesses, which include the digital skills of employees, and concerns about cyber security:

- **Digital skills:** Small business owners and their employees can lack digital skills. 42 per cent of small businesses viewed digital skills as being important to their future growth prospects. However, there is a significant skills shortage, particularly among older employees. 43 per cent of the over-50s were viewed as not possessing sufficient digital skills by companies looking to recruit new workers.
- **Cyber-security:** Fears over vulnerability to cyber-attacks can lead some small businesses to limit their use of online technologies. Again, firms struggle to assess the risks posed to cyber security with many failing to take sufficient precautions to protect themselves.

Our research was launched at a roundtable event where both Anna Soubry and Ed Vaizey, Ministers for small businesses and for the digital economy spoke. Key industry stakeholders also spoke about the importance of improving small businesses ability to make full use of digital technology.

fsb Experts in Business

# DIGITAL CONNECTIVITY = PRODUCTIVITY AND GROWTH

"Sales grew **40%** in a year due to being online"

FSB Member

## CONNECTIVITY

**75%** of members say broadband is vital to business

**70%** of members say mobile phones are vital to business

## SUPERFAST BROADBAND

**27%** use it

**46%** would like to upgrade to superfast broadband

## BENEFITS OF CONNECTIVITY

**94%** of businesses interact with customers and suppliers online

**94%** of businesses use internet banking

**70%** of businesses use connectivity to innovate

**51%** of firms do business online

**15%** plan to in the future

## BUSINESSES USING INNOVATION

**65%** use social media

**55%** use cloud computing

**11%** have an app

**42%** see digital skills as important for future business growth

Verve: Telecoms Survey

# SEVERE WEATHER RESEARCH: A MORE RESILIENT SMALL BUSINESS COMMUNITY

The recent flooding that badly affected parts of the UK over the Christmas period was just the latest reminder of the impact that severe weather can have on our communities and small businesses, as well as our wider economy. Many homes and businesses, particularly in the North of England and Scotland, will now face months and years of uncertainty as they attempt to rebuild their lives and livelihoods. Early estimates suggest that the combined economic impact of storms Desmond, Frank and Eva could exceed £3 billion. But even this figure may not fully account for all the indirect and ongoing economic consequences of the widespread disruption to infrastructure, transport and utilities.

As our climate becomes increasingly volatile, more needs to be done to prepare and protect small businesses in the future. In recent years, severe weather has regularly been the number one cause of business disruption in the UK. River and coastal flooding, surface water, snow and cold temperatures, water shortage, wind damage and heat-waves all have the potential to impact on the day-to-day activities of small firms.

This report is designed to inform the ongoing policy debate around the UK's resilience to severe weather, both today and in the future. It addresses some of the long-standing gaps in our knowledge and provides empirical evidence which, added to existing data, can provide a sound basis on which to make long-term policy decisions. Of particular note, in this context, is the work of the Adaptation Sub Committee of the Committee on Climate Change, and the ongoing work to inform the UK Government's next Climate Change Risk Assessment, due in 2017.

**Summary of findings:**

- Two thirds of small businesses say they have been negatively affected by severe weather in the last three years.
- The financial cost of these severe weather events over this period was, on average, just under £7,000 for each affected business.
- Disruption to people (customers and staff) and logistics (supply chain, utilities and transport) are the most frequently occurring problems for small businesses during severe weather events.
- Only 25 per cent of microbusinesses (those with fewer than 10 employees) have a resilience plan in place that specifically includes severe weather.
- 93 per cent of small businesses believe severe weather poses a risk to some part of their business.
- Only 19 per cent of small businesses have taken action to manage the impact of severe weather on their supply chain.
- 44 per cent of small businesses say they do not get information about severe weather resilience from any external source.
- Nine per cent of small businesses at risk of flooding say they have difficulty finding flood insurance.

## TOP TIPS FOR SMALLER BUSINESSES IN EXTREME WEATHER

1. Check your flood risk and sign up to Floodline Warnings Direct
2. Plan for the worst with a simple flood plan
3. Carry out an online Business Resilience Healthcheck
4. Consider insurance for direct and indirect impacts of severe weather

*Find out more at
**www.gov.uk/browse/environment-countryside/flooding-extreme-weather**

**#whatevertheweather**

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## IS YOUR BUSINESS PREPARED #whatevertheweather?

**65%** of smaller businesses have been impacted by severe weather in the last three years

Severe weather costs on average **£2,500** a year for affected smaller businesses

**75%** of smaller firms have no resilience plan in place

**54%** do not have business interruption insurance

**81%** have taken no action to manage risks to their supply chain

**#whatevertheweather**

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## FLOOD INSURANCE FACTS

**Smaller businesses are excluded from the Government's flood deal to guarantee affordable flood insurance**

**52%** of smaller firms on floodplains do not have flood insurance

**75,000*** smaller firms at risk of flooding have difficulty finding flood insurance

*Full referencing available **www.fsb.org.uk/media-centre/latest-news/2015/12/15/flood-insurance-facts**

**#whatevertheweather**

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# EU MEMBERSHIP RESEARCH

Following the General Election, the new Government confirmed its plans to hold a referendum on the UK's membership of the European Union (EU) by the end of 2017. The FSB decided to find out what small business owners really thought about the EU, taking a snapshot of current member views and exploring what they needed to know in advance of the referendum, to make the right choice for them and their business. Our role will be to ensure that the voice of small businesses is heard in the debate. It is crucial that members have access to all the information they need to make a decision that is right for them and their business.

The key findings from the research are:

1. Although the majority of FSB members have a view on the EU membership debate, fewer than half claim to feel 'informed' about the forthcoming referendum from a business point of view.
2. Opinion is divided on whether the UK's existing membership of the EU is beneficial for the UK economy and/or for a member's business. Opinions also vary across the membership on whether it is beneficial for their nation, region, or themselves personally. Members take into account a number of factors when making their assessment, but these factors are not exclusively business-related: for many, the business and the personal viewpoint are hard to separate in practice.
3. At this point in time, if a referendum were held today, and based upon the information they know now, 47% of FSB members would vote 'Yes', the UK should remain a member of the EU; 40.9% of FSB members would vote 'No', the UK should NOT remain a member of the EU; and 10.7% would be 'Undecided'. Beyond the simple 'in' or 'out' question, opinion is divided on both sides of the vote as to which scenario they would like to see happen if the UK were either to remain or to leave the EU.
4. There is a clear and widespread desire among FSB members for access to more neutral information about the EU referendum in the run-up to the vote. As noted, this research evaluates current opinions and intentions, based on members' present level of knowledge of the issues and potential outcomes of either leaving the EU or remaining a member. It also evaluates responses to the original wording of the EU referendum question, which was amended after the research fieldwork had taken place.

### Although the majority of FSB members have formed a view on the EU membership debate, fewer than half claim to feel 'informed' about the forthcoming referendum from a business point of view

78% of FSB members claim to have a firm view regarding the UK's membership of the EU. However, their responses in both the quantitative and qualitative phases of the research showed that many believe they are basing their views on an incomplete understanding of the EU. They also felt they lacked clarity on the impact of the UK's membership of the EU on the UK economy in general, and specifically on their own business.

Lack of understanding and a need for clear unbiased information is a consistent theme throughout the research:

- Fewer than half (40.8%) say that they feel 'informed' about the forthcoming referendum from a business point of view.
- Only one in five (19.2%) feel 'very well' informed about the EU referendum from a business point of view.
- A third of those who claim they would vote 'Yes' (31.8%) or 'No' (32.9%) (if the referendum were held today) feel they are 'not informed'

### Opinion is divided on whether the UK's existing membership of the EU is beneficial for the UK economy and/or for a member's business

Opinions on whether the UK's existing membership of the EU is beneficial are varied. The perceived impact of the EU on the UK economy, members' businesses, or members personally, differs widely. Overall, 50.5% of FSB members believe that the UK's existing membership of the EU is beneficial for the UK economy; however that contrasts with only 34.9% believing that it is beneficial for their own business. The picture beneath this result is nuanced: members who are more likely to see the EU as beneficial are those that rely on exports or imports from the EU and/or employ non-UK EU nationals.

Conversely, members who do not rely on EU imports and exports are less likely to see the EU as beneficial. We observe similar differences among the individual nations and regions, with some seeing the UK's membership of the EU being more beneficial for the UK economy or their business than others. Regarding the perceived impact of remaining in or leaving the EU, currently 41.3% of members anticipate that withdrawal from the EU would have a 'very' or 'somewhat' negative impact on their business.

In comparison, 20.3% perceive that remaining in the EU would have a negative impact on their business. Again, there are nuances in the results: for example, FSB members in certain UK nations and regions, those who rely on exports to or imports from the EU, and those who employ non-UK EU nationals, are more likely to anticipate a negative impact on their business if the UK was to leave the EU.

When asked to expand on their views, FSB members offer a wide variety of topics on which their views are based, including: freedom of movement; trade agreements; and regulation. However, their stance is not always based exclusively on business-related factors. This was illustrated in particular during the qualitative phase of our research. FSB members recognised that there could be a conflict in their own minds between the more specific business case, and the broader personal case, for or against EU membership.

### EU referendum: how would FSB members vote if it were held today?

If the EU referendum were held today, based on the information they know now, 47.0% of FSB members would vote 'Yes' for the UK to remain in the EU, 40.9% would vote 'No', and 10.7% would be undecided. As to be expected, a number of variations in voting intention are to be found beneath these headline figures:

- FSB members significantly more likely to vote 'Yes' are: exporters to the EU (66.3%), employers of non-UK EU nationals (60.7%), importers from the EU (56%), members in Scotland (59.9%), London (55.4%), and Northern Ireland (54.2%), and female business owners (51.3%).
- There are also regional differences within England in voting intention. FSB members significantly more likely to vote 'No' are: those who voted 'No' in the UK European Economic Community (EEC) membership referendum in 1975 (86.3%), members in East Midlands (48.7%), Yorkshire and Humber (47.8%), and the West Midlands (47%), male FSB members (43.3%) and those who don't rely on exports (43.3%).

In the qualitative part of the research, FSB members expanded on their views regarding the Government's current negotiations relating to the UK-EU relationship. While FSB members expressed a desire to see reforms, they found it difficult to specify exactly what reforms are needed. This may be due to members feeling they lack the relevant information regarding the negotiations and the potential impact any reforms may have on their business.

### There is a widespread desire for access to more neutral information about the EU

FSB members cite their main sources of information about the EU as being TV / radio (71.9%) and press / printed media (57.6%). As noted above, however, the online survey also showed that less than half of members (40.8%) say that they feel 'informed' about the forthcoming referendum from a business point of view.

During the online discussion forums, it emerged on a very consistent basis that members are concerned that mainstream media sources are sometimes unreliable or biased. They are also concerned that easy to understand, balanced information on the EU in general, and the UK's membership of the EU in particular, is not widely available. FSB members therefore want a clear, unbiased and balanced communication of the facts surrounding the UK-EU relationship. This is both as it exists today, and as it may become depending on the range of potential outcomes of the referendum.

# ENERGY EFFICIENCY RESEARCH

Almost a third of small firms highlight the cost of energy as a barrier to the growth and success of their business. Many small businesses share similar traits to households, in terms of their energy usage and expenditure. So finding energy efficiency savings could be the single best way of reducing their costs over the long-term. The Department of Energy and Climate Change estimate that the average SME could reduce its energy bills by 18-25% by installing energy efficiency measures, with an average payback of less than 1.5 years.

However, many small businesses do not feel empowered to make these savings because of a lack of information, available cash, or suitable motivation. Promoting energy efficiency is in the interest of consumers (cheaper bills), government (targets met) and energy companies (better risk and supply management). But, like the domestic audience, it has been difficult to persuade small businesses to invest in significant energy performance improvements.

Small businesses need support and information to help make these savings wherever possible. FSB has been keen to explore the factors that prevent or promote the implementation of energy saving by small businesses. In January 2015, 1,077 FSB members responded to a survey on energy efficiency.

The FSB survey suggested that many small businesses have already made first steps to becoming more energy efficient. 58 per cent of those surveyed said they had made changes to improve the energy efficiency of their business. This figure increases with the size of the business. The most widely reported measures were the installations of more efficient lights, lamps and bulbs (40%), switch off/turn down policies (23%) and improved insulation (23%).

The vast majority of surveyed businesses (90%) wanted to be energy efficient and said they saw the direct benefits of energy efficiency (86%). The majority thought energy efficiency was important for saving money (78%), protecting the environment (70%) and increasing profits (67%).

Despite the high number of businesses recognising the value of energy efficiency measures, not all firms are taking action and far fewer are making significant changes. Small businesses are hugely diverse and – depending on their type, location and circumstances – they are both persuaded and dissuaded on energy efficiency by a number of interacting factors.

The FSB survey results suggested that the main practical issue preventing many small businesses becoming energy efficient is that they operate from leased/rented premises (45%). This reduces their power to make physical changes to their property and, depending on their arrangements, can minimise or cast uncertainty on any potential savings they hope to make form any investment.

The survey also showed that the single biggest behavioural reason preventing many small businesses becoming energy efficient is the fact that a large proportion of them (45%) are simply not concerned about their energy costs. This isn't indicative of small businesses as a whole, but does reflect the diversity of small businesses across the UK. It is clear that not all businesses are driven purely by the potential to save cash. However, many are. It depends on their circumstances. In this respect, concerns around access to finance and available capital were highlighted by less than a third of FSB members (29%). However, for the minority of small businesses that do struggle with finance, it is clearly a major factor that must be addressed.

Other reported concerns included uncertainty around return on investment (28%), or that this return will take too long (26%). Less frequently reported issues were a lack of information about options (20%), concerns about business disruption while improvements were being installed (11%), and a lack of affordable finance (7%).

Most small businesses say they require a fairly quick return on their energy efficiency investment. 55 per cent require a return on their investment within two years and 39 per cent would require a return within one year.

There is clearly no silver bullet for addressing the barriers that small businesses face in becoming energy efficient. There is a clear need for market segmentation, in terms of policy making. A business that is not concerned about their energy bills may not be motivated by the potential for cost savings, but may be motivated by other factors – like environmental responsibility, profit margins and attractiveness to customers.

## The energy market was also investigated by the CMA

The Competition and Markets Authority (CMA) have been investigating the energy market for the past year. This review covers England, Wales and Scotland, but not Northern Ireland which has a separate regulatory regime. Following substantial engagement with FSB, the CMA agreed to look at 'microbusinesses' as a specific audience within the wider market investigation.

Like domestic customers, most small businesses do not currently engage with the energy market. Many do not trust the industry and feel disempowered to make positive choices. Many smaller business owners highlighted difficulties in comparing contracts, unclear terms and conditions, unfair automatic rollovers, and a lack of confidence in Third Party Intermediaries (TPIs) as major barriers to getting the best energy deal. Only a quarter of FSB members believe there is enough competition in the energy market and four out of five believe that their energy suppliers do not care about their needs.

It is clear the time and resource costs associated with searching for a new energy deal are simply too high for many small businesses to feel the process is worthwhile. FSB believes that published, comparable tariffs would benefit the market. These transparent tariffs would lower the costs associated with searching for a new deal, and thereby encourage competition by making it easier to switch accounts on the basis of full and clear information.

After looking at all the evidence, the CMA's interim findings suggest that smaller businesses are paying around £500 million a year too much for their energy. They conclude that microbusinesses suffer in the market as a result of a lack of comparable tariffs, mistrust of TPIs, and higher margins compared to domestic contracts that can't be accounted for by additional risk.

To address these issues, the CMA has also proposed a number of remedies for consultation. These include: a price comparison service for domestic and microbusiness customers; published price lists for microbusinesses on supplier websites; the introduction of new rules governing the information that TPIs are required to provide to customers; and the abolition of unfair automatic rollover contracts with narrow windows for switching.

The CMA is due to release their final report in early 2016 and the fine detail behind many of these remedies will then need to be negotiated. FSB is confident in achieving a major step forward in improving the market for small businesses.

# LOCAL BUSINESS SUPPORT REVIEW

Where it has been effectively applied, business support has played a crucial role in adding value to businesses and the wider economy, but the policy decisions made nationally and locally over numerous years have not provided a coherent support system that businesses understand. There has been a failure of co-ordination between public and private sector provision, both of which are crucial to the wider picture. Equally, the low level of evidence in this area means there is limited knowledge of whether many of the interventions that have been put in place have had a positive effect, let alone which provide the best value for money.

The current business support framework represents a lost opportunity in terms of local growth and prosperity. Significant investment has been made over many years, and yet there is little understanding of how it has or has not impacted on the economy. FSB is determined to change this, and has provided this paper to help Local Enterprise Partnerships (LEPs) in England and others to work together to develop a cohesive system of business support that is effective in adding value, is sustainable, and is understandable for businesses.

The development of LEPs and the establishment of Growth Hubs, combined with the review of national business support and planned reviews of local business support, present us with an unparalleled opportunity to think strategically about the kind of support environment that business needs. There are LEPs who have adopted appropriate business support design principles. However, many LEPs lack the capacity or capability to do this and will need support to provide coherent and effective support. All LEPs need to develop their business support framework on a solid evidence base and adhere to robust evaluation methods.

Despite improving economic performance, the UK still has fundamental economic weaknesses that can be improved by effective business support.

Economic strengths and weaknesses can also be identified at local and regional level, and vary significantly across the UK. This must guide the approach to local interventions.

Business support is currently under-used, with many businesses unaware of availability, and even their need for support.

Business support at both the national and local level has been characterised over many years by confusion, duplication and a lack of a comprehensive overarching strategy to define what outcomes support is being designed to achieve, and how initiatives work together.

Changes have been made to streamline the national business support offer to make it more accessible to businesses, and over the next year LEPs will be asked to follow the same process at a local level – this is a golden opportunity to make local business support more coherent and effective.

Growth Hubs can provide a single focus for the delivery of business support locally, but it is crucial that LEPs use and co-ordinate their activities with Growth Hubs to ensure that the shared goals of the area are delivered.

## Key principles of targeted programmes for growth businesses

1. **Enabling self-selection –** setting up the scheme so that it gives a clear indication of what is required and who should apply
2. **Selecting participants –** making sure those who participate are likely to complete the training and therefore succeed
3. **Recognising impact on wider system –** selecting to recognise the potential for positive spill-overs while minimising displacement
4. **Sustained engagement –** the need to provide continuing engagement over a number of years
5. **Holistic approaches –** looking at the whole of the business and its needs
6. **Partnership based –** drawing on the expertise and networks of a range of local support organisations using and building on existing private sector provision wherever possible
7. **Regionally organised –** providing more opportunities for event attendance and networking

# LATE PAYMENT RESEARCH

FSB is driving the campaign to change the culture of poor payment practices which leaves smaller business suppliers out of pocket and struggling with their cash flow. The use of poor payment practices by business customers who have already benefited from goods or services that have been supplied, has significant follow-on effects that can impede the capacity of smaller businesses to invest in their staff, and grow. Our research found that poor payment practices canlead to reduced profitability (34%), firms paying their own suppliers late (32%), and restricted business growth (29%). In some cases it threatens the existence of the supplier.

The issue for smaller businesses is that where they have less negotiation power than their larger business customers they can be less able to get a fair deal in the contract. Alongside this, smaller businesses have reported that they risk losing valuable contracts if they challenge or take legal action against their business customers, such as charging interest on overdue payments.

FSB research found the most common poor payment practices were:

- **Flat fees -** Also known as supplier assessment charges or supplier investment payments. These are flat charges which companies levy on suppliers either as a requirement to be on a supplier list, or packaged as an investment into future business opportunities. It can be indicated that non-payment will result in de-listing.
- **Excessively long payment terms -** UK implementation of the EU late payment directive allows businesses to agree longer terms ‘provided it is not unfair to the creditor’. This has led to terms of 90 and 120 days.
- **Exceeding payment terms -** Customers exceed or change agreed terms retrospectively which means they do not have to meet payment dates. The practice of extending payment dates if money is owed on, or close to, the end of a financial reporting date has been used to balance the companies’ financial statements.
- **Discounts for prompt payment -** Customers apply the discount to themselves for paying early or on time. For example, a firm that has agreed to pay 120 days following receipt of an invoice would apply a discount of 3% if they pay on or before the 120th day.
- **Retrospective discounting -** Customers apply retrospective discounts to outstanding money owed to smaller business suppliers. The customer changes the terms of the contract that has already been signed. Smaller businesses have said they have had threats of delisting, withholding payment, or being invited to pay‘marketing contributions’.
- **Late challenge on invoices -** Payment is delayed when customers challenge the invoice near the due date instead of earlier for example, within 21 days of confirming receipt of invoice.

The extent of the issue is shown in BACS research that found, in 2014, that UK businesses were owed £46.1 billion in late payments. 60% of small and medium sized businesses were affected and they were owed the average sum of £38,186.

FSB research into the poor payment practices of the business customers of smaller businesses found:

- 51% of FSB members were paid late
- Almost one in five (17%) of smaller businesses said they faced supply chain bullying in one form or another in the past two years
- More than a quarter of a million smaller businesses could face flat fee charges (based on 5% of the smaller businesses surveyed saying they had been asked to make a payment by a customer or face delisting)

The evidence from this research has underpinned FSB’s campaign for Government to tackle the culture of poor payment practices and to adopt the standards set out in the EC Directive on Late Payments and in Northern Ireland small businesses want government to enforce payment deadlines. FSB’s campaign will continue until there is a change in the culture of poor payment practices that is evidenced by not only a significant reduction in the number of small businesses affected by poor payment practices but also evidence of year-on-year adherence to the payment terms of contracts that are negotiated fairly.

# EMPLOYMENT COSTS REPORT

Over the past year, the labour market has continued to improve with unemployment reaching pre-crisis lows and the employment rate at the highest level on record. While the pace of labour market recovery slowed earlier in the year, it picked up again in the second half of 2015 and continues to outperform those of our European neighbours.

Strong labour market performance, leading to increased hiring competition, has started to feed through into wages. FSB members continue to say that wage inflation is an important driver of costs, with 44.7 per cent of firms citing labour as the main driver of changes to operational costs in Q4 2015.

Concerns about rising employment costs are supported by findings from our Employment Costs Index, a model which FSB has developed in partnership with the Cebr. The Index found that total employment costs for a typical small business (with six employees and one owner-manager) have increased by 0.5% between 2013 and 2014, taking the total cost of employment to £190,600 (compared to £189,600 in 2013). The increase in costs was primarily driven by wages.

FSB has cautioned policy makers that although small business confidence and hiring intentions have been strong in the past few years, the prospect of rising costs contributed to a marked cooling in confidence in the quarter following the Summer Budget, although business confidence has risen again in this quarter. It is likely that measures announced in the Budget, including the National Living Wage (NLW) - a new statutory rate for the over 25s which takes effect from 1st April 2016 - contributed to this dip in confidence. Concerns over statutory wage increases also come at a time when small business owners, many on modest incomes, are facing up to the additional costs to their business of pensions auto-enrolment – which will add further pressures to stretched budgets.

The Employment Costs Index modelled the costs to small business of the NLW. It estimates that for a small retail business with six full time staff aged 25 or over and earning the current adult minimum wage, the NLW will cost an extra £5,900 a year from April 2016.

As of October 2015, we estimate that annual labour costs for this business stand at approximately £127,700. Even after claiming the higher Employment Allowance (which is set to rise to £3,000 next year), these costs are set to rise to £133,600 in April 2016 due to the NLW. In other words, the £3,000 of potential savings to employers from lower national insurance contributions will reduce the £8,900 higher wage costs incurred in this case, but will still require this employer to find nearly £6,000 to cover the additional costs. This takes place just six months after employers have already increased wages due to the increase in the minimum wage on 1 October 2015.

# EDUCATION AND SKILLS RESEARCH

For many small businesses, investing in knowledge, skills and training of employees forms an integral part of their strategic approach, with 80% of small businesses recognising the benefit of staff training and development. Small businesses are adopting a variety of approaches to up skilling employees, with the majority offering informal on-the-job training (81%) and almost half (40%) offering personal development or 'soft skills' training.

The Government wants to see employers place greater focus on investing in their businesses and maximising growth and productivity in the years to come – an appetite which is shared by the majority (80%) of small firms who report to be ambitious about growing their business and are thinking strategically about how to get there (84%).

Despite staff training and development being important to small businesses, the high proportion of employers using informal training suggests that small firms continue to face a number of barriers affecting their ability to invest in the skills. The biggest single barrier to investment is the cost of training (43%).

Small businesses need to be supported to identify training solutions which meet the needs of their business and is cost-effective. Small firms would also benefit from improved access to information, particularly in regards funding for training which could help to increase their overall levels of investment.

Businesses identified employee's 'general attitude to work' and 'communication skills' as both the most important skills to business growth and the skills that were most lacking when recruiting – particularly among younger workers. In Scotland, 30 per cent of smaller businesses say skills shortages are a barrier to growth. In Northern Ireland, a lack of basic work skills, such as literacy, numeracy, IT and social skills, has been persistently highlighted by FSB members in surveys: 61% of small employers are not confident that they will find a candidate with the right skills. The majority of small businesses (73%) feel that school and college leavers are the least prepared for the workplace.

The 'employability' skills small businesses are looking for can be effectively developed by establishing closer ties between education and employers. Almost all (90%) small firms believe employers can make an important contribution to educating students about careers in schools and colleges; yet, currently only around a fifth (14%) have any involvement with a school or college, and a further 56% of small businesses have never engaged with schools or colleges.

Although there is a clear appetite to help young people learn about careers and the workplace, there are challenges standing in the way of successful engagement, including business owners concerns over impact of time spent away from the business (67%) and the financial implications of engaging (30%). In order to facilitate increased engagement with education, small businesses say they require guidance on opportunities available and ways to get involved, financial incentives to counterbalance the cost of taking part and a greater emphasis on workplace skills in education.

# DEVOLUTION: CHALLENGES AND OPPORTUNITIES

In England, FSB is broadly supportive of measures to devolve more powers to local areas. This is premised on our view that local people and businesses are best placed to make decisions in the interest of their areas.

FSB recognises that greater powers should go hand in hand with local accountability, and that while decentralisation has the potential to bring significant economic benefits, in some areas of policy, businesses will have concerns over the extent to which power is devolved.

During his speech at the Conservative Party Conference this year, the Chancellor made a surprise announcement devolving business rates to local councils across the UK. This included limited rate setting powers, subject to business approval within different areas. Combined authorities and local councils will have the power to reduce business rates in areas where an elected mayoral position had been created within a devolution settlement.

Although debate on devolution to various parts of the UK has a long history, the current devolution agenda began in earnest in 1999 with the establishment of devolved administrations for Scotland Wales and Northern Ireland, as well as the Greater London Authority (GLA) in London. For England, the latter is significant as it established the principle that devolution could take place based on something other than a shared national identity.

The devolution journey for England has been more complex and based on a series of individually negotiated agreements between localities and central government. It began with the City Deals for the eight largest “Core Cities” in England outside London in a process repeated for the 20 Wave Two City Deal areas. The City Deal concept was also extended beyond England to include Glasgow and Cardiff in 2015. The negotiated deal model was repeated for the 39 Local Enterprise Partnerships in relation to Local Growth Fund allocations.

Following the Chancellor’s announcement, it is likely that the path will continue to be based on asymmetrically negotiated deals with the onus on local areas to proactively set out what they can do and what they need to deliver. Increasing numbers of deals have been announced with new Combined Authorities. The sole requirement from central Government to date has been that these areas establish an elected mayoral position.

The Government has also proceeded with a manifesto pledge to introduce an English votes for English laws Bill to address concerns over the ability of Scottish MPs to vote on laws affecting only England or England and Wales.

In Wales, FSB is calling on the next Welsh Government to devolve a statutory responsibility for local economic development and regeneration, together with all relevant staff and budgets from Welsh Government, to the proposed larger local authorities.

# APPRENTICESHIPS

A third (33%) of smaller businesses in England have employed an apprentice. Almost half (46%) of businesses which hired an apprentice in the last 10 years recruited between two and five individuals, suggesting that for many businesses, apprenticeships form part of a longer-term strategy to recruit and train employees, build a pipeline of skills and address present and future skills shortages.

In recent years the Government has been focussed on encouraging employers in England to invest in the skills of their workforce to meet the demands of their business and an increasingly global economy. Against the backdrop of high levels of youth unemployment and criticism over the lack of vocational pathways for young people, apprenticeships have been identified as a key way to increase investment in skills and training whilst boosting the number of young people in the labour market.

As part of the Government's steps to reform the apprenticeship system in England, they have pledged to create three million new apprenticeship starts by 2020. Small businesses are an important part of meeting this target. Furthermore, with the Government announcing in this year's Autumn Statement a 0.5% levy on firms whose total payroll exceeds £3 million (with employers receiving an allowance of £15,000 to offset against their levy payments), businesses are being asked to consider how and where an apprentice could contribute to their operations.

Most small businesses recognise the role apprenticeships play in preparing the next generation of skilled workers, with many survey respondents agreeing that the main motivation for taking on apprentices is that they offer an effective route to achieving the required qualification for their trade. Furthermore, around 80% of small businesses have offered jobs to at least half of their apprentices after completing their apprenticeship, suggesting that overall levels of satisfaction with participants on these programmes is high.

Although there is evidence that many small businesses are successfully engaging with apprenticeships, almost half of small business owners (42%) lack confidence in the ability of the system to deliver high quality apprentices.

Perceptions surrounding apprenticeship quality is therefore a key challenge preventing small business from taking on an apprentice. To address this, the Government is reforming the apprenticeship system in England by, among other things, inviting groups of employers or 'Trailblazers' to design new apprenticeship standards and assessment approaches for their industry to ensure apprenticeship training is relevant, high quality and future-facing.

Indeed, steps such as these may encourage greater engagement from small businesses, with the almost half (44%) of survey respondents suggesting that greater employer involvement in the content of apprenticeship standards and training would encourage them to reconsider apprenticeships.

In Northern Ireland a new apprenticeship strategy, Securing Our Success (due to commence in 2016) is similarly focused on placing employers in the lead role in ensuring the provision and content of apprenticeships meets their needs and young people benefit from relevant, high quality programmes. FSB Northern Ireland has provided significant input into the review of the strategy and will continue to press the Assembly to ensure the new policy commitments and implementation plan delivers for small businesses in Northern Ireland.

FSB is supportive of changes that could be made to the apprenticeship system in England to create a high quality programme that puts employers at the centre; however we are mindful that the challenges for smaller firms in taking on apprenticeships are different to those facing larger employers and continue to play a key part in this and will continue to work with the Government on this. Any changes to the apprenticeship system need to take into consideration the needs and interests of small businesses if they are to be successful and sustainable, and to prioritise quality over quantity.

# WAGES

Following the recession, many small businesses responded to falling demand and consumer confidence by reducing working hours or freezing or lowering staff wages. But after several years of pay restraint, there is growing evidence that small businesses are now increasing wages.

The SBI finds that average pay growth in small businesses stood at 2.3% per cent in the final quarter of 2015, compared to 1.4% per cent a year earlier, while firms expect average pay growth to rise to 2.7% per cent over the next twelve months. This represents the fastest wage growth since the SBI began. With historically low rates of inflation, real terms growth in wages should provide a welcome boost to consumer spending – which the OBR suggests will continue to be one of the key drivers of economic expansion in the years ahead.

Rising wages is likely to be in response to several factors, not least improvements in the economy as well as skills shortages brought about by a tightening of the labour market. Furthermore, increases in the National Minimum Wage have outpaced growth in average earnings in recent years, and are therefore helping to push up labour costs for employers.

Many small firms will be able to accommodate gradual increases in the minimum wage at this stage in the economic cycle, while others will be unaffected as they pay higher wages. 34 per cent of small employers said that the recent increase in the minimum wage on 1 October 2015 (to £6.70 an hour for adults) would have either no impact on their business because they pay higher wages, while a further 33 per cent would experience either zero or marginal impact.

This is not universally the case and in certain sectors and regions of the UK, small businesses will struggle to absorb the cost of minimum wage increases, particularly when the new NLW – a higher, age-specific rate for the over 25s - comes in from April 2016. Starting at of £7.20 an hour, the Government wants the rate to rise to at least £9 an hour, or the equivalent 60 per cent of average earnings, by 2020.

38 per cent of small employers expect the introduction of the NLW in April 2016 will have a negative impact on their business. In Northern Ireland, while almost three quarters of small businesses pay staff the living wage or above, the mandatory NLW is expected to severely impact those small business owners that cannot pass on the costs to customers. The impact is likely to be most highly felt in sectors such as retail, accommodation and food services, and social care where operating margins tend to be fine. Only six percent of businesses say it will have a positive impact.

Of those businesses negatively affected, over half (52%) say they will put off hiring new staff, while 50 per cent say they will raise their prices. 41 per cent say they will cut staff hours, 31 per cent will reduce staff numbers, 29 per cent will cancel or postpone planned investments, while 26 per cent will erode pay differentials by freezing or cutting the wages of higher paid staff. Almost a third of negatively affected businesses owners expected to absorb the cost through reduced profits (29%).

In light of the introduction of the NLW, the Government and Low Pay Commission will need to monitor its impact carefully, and help affected firms adapt to the change particularly where the potential for productivity gains are limited. This is especially important in view of other developments occurring simultaneously, notably the requirement to automatically enrol workers in a workplace pension scheme.

Among other things, FSB has called for the level of the Employment Allowance to be reviewed to ensure it is set at a sufficient level to help businesses offset the costs of NLW. Our analysis suggests that for many small firms, a rise in the allowance to £3,000 will be insufficient to cover the extra costs – and other measures may be needed. In the largely publicly-funded care sector, policymakers must also ensure that services are adequately funded to enable providers to meet the costs of the NLW.

FSB has always supported the National Minimum Wage, however we do have concerns about the pressures the NLW will create for many small firms and its impact on the labour market. At the same time, the NLW needs to be widely communicated to employers ahead of its introduction. While FSB fully supports a zero tolerance approach to abuse of the minimum wage, clear communication is needed to prevent employers inadvertently falling foul of this change in the legislation.

# CMA REVIEW OF THE RETAIL BANKING MARKET

FSB welcomed the CMA retail banking market review which commenced this year. It is clear that there are features of concern within the retail market that needed to be addressed to deliver a finance market that meets the needs of smaller businesses.

Finance enables businesses to start-up, scale-up¸and raise productivity through investment in staff, improvements to processes and infrastructure, and the development of innovative products. However, over a number of years the SBI has consistently highlighted that the majority of smaller businesses do not seek external business finance.

This as an ongoing trend and current data shows only 13% of smaller businesses applied for bank credit and around 2% sought alternative finance such as peer-to-peer crowd funding. This trend strongly indicates that the retail banking market continues to underperform.

To date, the CMA has 'provisionally found that the combination of barriers to searching, product linkages, the nature of demand for small business lending products, information asymmetries and incumbency advantages in the provision of small business lending in both Great Britain and Northern Ireland is leading to an adverse effect on competition. The preliminary recommendations to these findings are a solid start to reform the finance market.

FSB believes the underperformance of the retail banking market is due to the market being overly concentrated, with around 85% of smaller businesses relying on bank finance. The predominant use of bank finance from the main high street banks and subdued demand from smaller businesses for other products has meant there are low levels of competition to improve or develop new products, and fewer challenger banks and alternative finance providers entered the market.

Alongside the constrained choice of financial products and services, British Business Bank research has found that smaller business have a low awareness of the range of non-bank alternative finance options available to them. The lack of choice and low awareness of the products that are available has meant that some smaller businesses - in particular those who need low levels of finance - struggle to access the right type of finance for the life stage of their business.

FSB will continue to engage with the CMA to strengthen any proposed reforms to the retail banking sector.

# METHODOLOGY

This report is based on the October-November 2015 research survey of FSB members carried out by Verve. All FSB members (126,778) for who a valid email address was held and who agreed to be contacted by the FSB were invited to participate in an online survey. Reminders were sent to all non-respondents. 3,102 responses were received, a response rate of 2%. The data is weighted by regional gross value added to match the profile of small businesses across the UK. The survey was undertaken between 19 October and 9 November 2015.

The research summaries provided as part of the Annual Review 2015 are based on survey results carried out by Verve over the course of 2015, along with FSB analysis of different policy areas. Surveys were carried out on the Big Voice community, an online survey panel of small business owners. Response rates varied between different surveys.

# SUMMARY DATA TABLE

| | 2010 | 2011 | 2012 | 2013 | 2014 | Q1 2015 | Q2 2015 | Q3 2015 | Q4 2015 |
|---|---|---|---|---|---|---|---|---|---|
| Small Business Index | +1.0 | -6.6 | -1.7 | +19.3 | +33.5 | +28.7 | +37.9 | +20.3 | +21.7 |
| Employment - previous three months | -2.3% | -4.1% | -4.3% | -0.2% | +3.4% | +4.2% | +8.9% | 5.3% | +6.7% |
| Employment - coming three months | +0.9% | -3.4% | +0.4% | +3.6% | +8.0% | +10.0% | +14.2% | 8.2% | +7.3% |
| Revenue - previous three months | -5.1% | -4.7% | -4.1% | +6.0% | +18.3% | +19.5% | +24.1% | 18.8% | 23.9% |
| Revenue - coming three months | +7.2% | -3.5% | -1.7% | +13.3% | +28.1% | +28.5% | +32.1% | 26.1% | 24.4% |
| Investment intentions – coming 12 months | - | - | +11.5% | +15.9% | +24.9% | +24.9% | +31.9% | +22.0% | 22.5% |
| Credit availability – rated good or very good | - | - | 8.0% | 10.9% | 14.1% | 16.2% | 16.6% | 23.5% | 18.2% |
| Credit availability – rated poor or very poor | - | - | 71.4% | 65.7% | 58.4% | 50.4% | 47.3% | 41.6% | 43.6% |
| Credit affordability – rated good or very good | - | - | 12.6% | 16.3% | 19.3% | 19.6% | 26.2% | 27.6% | 23.3% |
| Credit affordability – rated poor or very poor | - | - | 60.7% | 55.1% | 50.6% | 46.4% | 42.4% | 38.8% | 40.7% |

Figures by year above are an average of the quarterly results.

The SBI weights strong responses (much improved or much deteriorated conditions) double and subtracts the weighted proportion of firms reporting deterioration in business prospects over the coming three months from the weighted proportion expecting an improvement.

The employment and revenue indicators are net percentage balances, with the proportion of firms reporting a decrease subtracted from the proportion reporting an increase.

Responses are also weighted according to regional gross value added.

INSIDE BACK COVER

# Q4



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