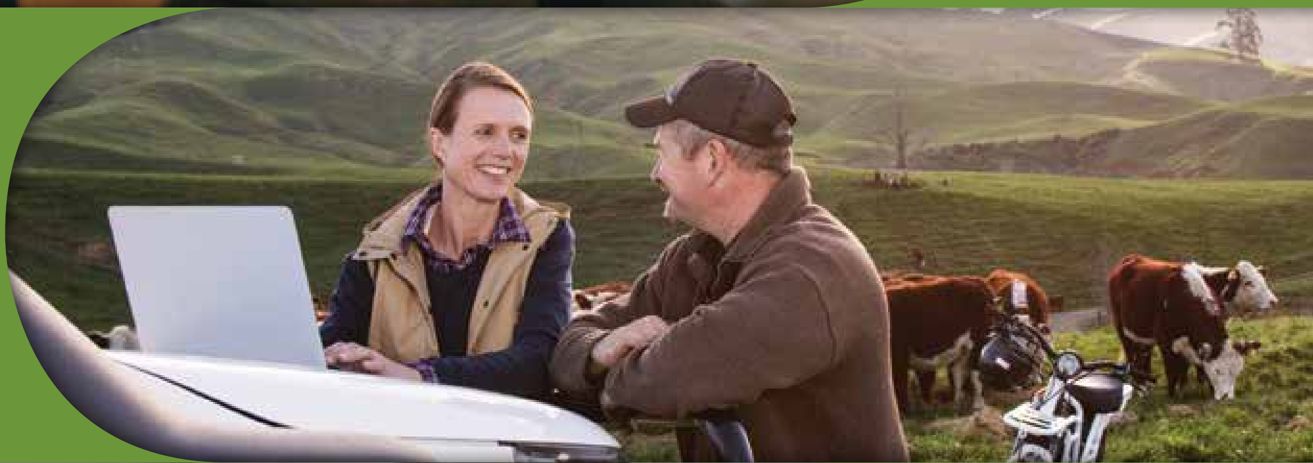
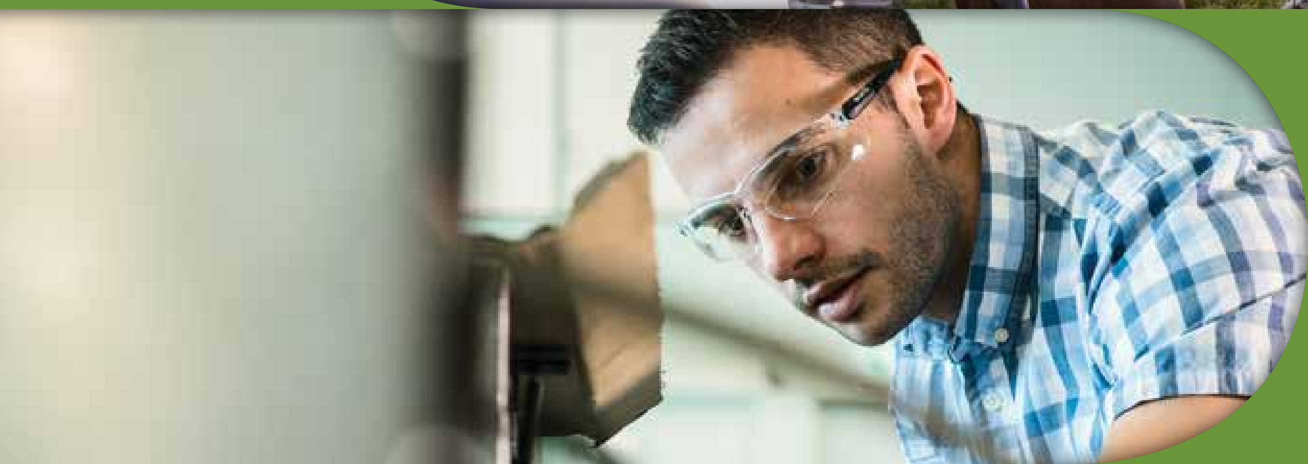
Defining Small Business

Recommendations of the New Zealand Small Business Council for the Minister of Small Business

JULY 2019





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The Small Business Council was established in August 2018 for a term of one year to advise the Government on strategic opportunities for improving the small business sector. The terms of reference for the Council state that the Council will:

> *"come up with a segmented definition for the SME sector, taking into account the size of businesses, that it can use for analysis, strategic development, and discourse with the view that the definition will be used across government e.g. micro, small, medium."*

This document sets out the Council's advice on this item from the terms of reference. The views presented in this report are that of the Council and do not reflect government policy.

Recommendations

The Small Business Council recommends that:

RECOMMENDATION 1: Adopt a flexible approach to how small business and the SME sector are defined across government. When targeting certain groups of businesses, government agencies should segment the business population in a manner appropriate to the purpose or the problem being addressed and consider how the context may change over time.

RECOMMEDNATION 2: Where it is necessary to target businesses by size or other categorisation, government should, where appropriate, aim to be inclusive in the way it segments the business population. This means that government should take an economy-wide view and ensure that support is provided to all businesses that need supporting, rather than restricted to those covered by a rigid definition.

RECOMMENDATION 3: When segmenting businesses by size, either for targeted interventions or more loosely in discourse, government should consider the present and future state of the business environment with particular regard to the future of work. With this point in mind, government should constantly monitor the effectiveness and appropriateness of any given segmentation to ensure that it remains relevant in the future.

Small businesses in New Zealand

New Zealand is a nation of small businesses. Of the approximately 535,000 businesses[1] in New Zealand, an estimated:

- 401,000 (70.5%) have no employees
- 101,000 (19%) have 1-5 employees
- 40,000 (7.5%) have 6-19 employees
- 10,000 (2%) have 20-49 employees
- 5,000 (1%) have 50 or more employees.

Small businesses are represented in every industry, have many different operating models and interact with government and the economy in a range of ways. From the local delivery driver transporting goods around our communities to the next high-tech start-up developing software to export across the globe, New Zealand's small businesses provide the goods and services that keep our communities moving and showcase New Zealand as a world-class place to visit, live and do business. Together, they form a vital part of the New Zealand economy and society.

[1] These statistics include economically significant enterprises that are engaged in producing goods and services in New Zealand. A full description of the sampling criteria can be found on the Statistics NZ website here - http://datainfoplus.stats.govt.nz/Item/nz.govt.stats/cdc1a229-6735-4960-baa4-190b721f8195

Common characteristics of small businesses

Small businesses are not all the same; there are more differences between them than similarities. However, in spite of the diversity in the small business sector, there are a number of distinctions between small businesses and their larger counterparts that are important in a policy context. The characteristics listed below are common among small businesses and small business owners, and have important implications for government when designing and implementing programmes to enable small businesses to fulfil their potential.

Small businesses commonly:

- are privately or family owned and operated and tightly controlled with no formal governance arrangements
- are constrained by a lack of access to resources, from management and funding to staff
- are isolated places to work for the owner manager and employees
- play a key role in the make-up of the social fabric of the community, particularly in provincial areas.

Small business owners commonly:

- pay their own wages and frequently operate with limited resources (including money, time and staff)
- wear multiple 'hats' and perform a range of functions
- do not seek advice from specialists or do not know where to get good advice
- operate on trust, rather than on systems and contracts
- have learned through experience and have little formal business training
- vary widely in their aspirations, backgrounds, and sophistication
- focus on a small range of products or services sold mainly on the local domestic market
- are not growth-oriented; for many owners the goal is to have a successful small business, not necessarily to grow larger.

Small businesses of tomorrow will be different

The above characteristics represent what many small businesses and their owners typically look like today. However, small businesses of tomorrow are likely to look very different.

Global drivers of change such as environmental degradation and climate change, social and demographic changes, evolving business models, and technological advancements mean that the world we live and do business in is changing at an accelerating rate. Our aging population, increasing ethnic diversity and urbanisation will change the profile of who owns small businesses and where they are located. The next generation of business people will be more digitally competent and confident, they will be digital natives. The rise of the gig economy and remote working will impact on the way small businesses interact with the economy. Emerging artificial intelligence and robotic technologies could result in businesses with fewer employees fulfilling the functions that have traditionally been filled by much larger businesses.

In 2018, approximately 61,000 small businesses were started and around 60,000 closed down. This rate of churn in the small business sector is the product of an increasingly dynamic business environment, and it enables the renewal necessary for the small business sector to adapt to a rapidly changing world. Sole traders are becoming increasingly common with the overall number increasing by around 45,000 or 12 per cent in the last 10 years compared with an increase of 1 per cent to 3 per cent across other segments.

As small businesses and their owners change to meet the challenges and opportunities of the future, the way government defines, thinks about and empowers small businesses also needs to be flexible so that it can keep pace with the changing nature of the sector and operating environment.

Currently used definitions

A definition is an exact statement or description of the nature, scope, or meaning of something. It enables a common understanding of the subject being defined, and enables the definer to demark what is included and excluded from a particular group.

Government sometimes needs to segment businesses by size so they can target support and regulations appropriately and have the highest chance of achieving the desired outcome. Similarly, when conducting market research or tailoring products to their client's needs, many private organisations that interact with the business community also segment business populations by size.

In a broader sense, it is useful for everyone to have a common understanding of how to describe businesses of different sizes. Common understandings help government to describe the small business sector in policies and initiatives, and for private organisations to communicate with, and market to, their customers.

In New Zealand there are a number of size-based measures commonly used to segment business populations. The most common measures used are number of full time equivalent (FTE) employees, annual turnover, total assets, or a combination of all three. Whichever measure is used, the selected definition generally attempts to segment business populations at the trigger points at which management practices for a business change. The following traditional method of segmenting businesses by number of employees illustrates how management practices change as a business grows:

- 0 employees – the owner works in the business. It is a job for them, they are responsible for their own performance and complete most business processes themselves.
- 1-5 FTE employees – the owner still works in the business. It is their job and they are also an employer of other people. They are responsible for hiring and managing employees and the associated human resource management and compliance tasks.
- 6-19 FTE employees – the owner manages the business rather than doing the work. They start delegating business compliance tasks such as accounting work to employees.
- 20 + FTE employees – the owner has a more strategic role, while others manage and do the work. They delegate more business and people management tasks such as human resource management.

Trigger points for changes in management practices for businesses with more than 20 FTE employees are less well-defined. Businesses with more than 20 FTE employees transition to more corporate business models at different points in their growth trajectory depending on a variety of factors unique to the business, industry, and owner. Generally, the larger the business the more power and influence it has over interactions and relationships with smaller businesses.

Definitions used in New Zealand

The table below outlines some of the ways government and private organisations in New Zealand define businesses by size.

PURPOSE FOR DEFINITION	DEFINITION	TERMINOLOGY
Identify which businesses to report on in the Small Business Fact Sheet (produced by MBIE)	Fewer than 20 employees	Small business
The Employment Relations Amendment Act 2018 allows businesses of this size to retain the right to use a 90-day trial for new employees	Fewer than 20 employees	Small-to-medium-sized employer
The Emergency Business Support Policy Framework (MBIE) supports businesses of this size	Fewer than 20 employees	Small business

PURPOSE FOR DEFINITION	DEFINITION	TERMINOLOGY
Statistics New Zealand surveys	Statistics New Zealand does not use any specific definition across all of their surveys. Instead, various employment and turnover measures are used to segment survey populations to target sampling, with the measure varying based on the requirements of the survey output	N/A
Business New Zealand	Commonly uses fewer than 20 employees, but may use other definitions depending on the circumstances	Small business
Xero	For communications purposes a measure of fewer than 20 employees is used. For research purposes Xero segments businesses depending on the requirement of the output	Small business
Inland Revenue's customer segments	Inland Revenue arranges its activity and organisation around customer segments Micro – fewer than 6 employees, or less than $1 million GST turnover Small and medium – 6 to 49 employees, or $1 million to less than $30 million of GST turnover (for some research purposes small businesses are segmented separately as those businesses with 6 to 19 employees)	• Micro sized trading and most non-trading entities • Small and medium sized trading entities
Inland Revenue uses this measure to decide whether a business is required to register for Goods and Services Tax	Turnover of less than $60,000 in the previous 12 months and projected turnover of less than $60,000 in the following 12 months	Businesses of this size do not need to register for GST.

Definitions of small business used internationally

Most countries use specific size-based definitions to describe businesses. How countries segment their business population varies widely depending on the size of economy, relationships to other markets, and the size profile of businesses in that country.

New Zealand's business community and government commonly use the following definitions in discourse:

- sole trader – 0 employees
- micro business – 1 to 5 FTE employees
- small business – 0 to 19 FTE employees
- medium business – 20 to 49 FTE employees
- small and medium enterprise (SME) – 0 to 49 FTE employees
- large business – 50 or more FTE employees

The table below outlines definitions of small business commonly used within the listed countries.

COUNTRY/AREA	SMALL BUSINESS DEFINITION COMMONLY USED IN DISCOURSE
New Zealand	Fewer than 20 employees
Australia	Fewer than 20 employees
Denmark	10 to 49 employees. Businesses with 0 to 9 employees are classified as micro
Ireland	Fewer than 50 employees
Israel	Fewer than 100 employees

COUNTRY/AREA	SMALL BUSINESS DEFINITION COMMONLY USED IN DISCOURSE
The United Kingdom	10 to 49 employees. Businesses with 0 to 9 employees are classified as micro
European Union	Fewer than 50 employees and less than €10 million in annual turnover and/or total assets
United States of America	Fewer than 500 employees for manufacturing businesses. Less than $7.5m in annual receipts[2] for most non-manufacturing businesses
China	Businesses are classified differently depending on the industry they operate in. For example, construction companies with fewer than 600 employees, less than RMB40 million in total assets and less than RMB30 million turnover are classified as small businesses. On the opposite end of the spectrum, to be classified small, businesses in the retail industry must have fewer than 100 employees and less than RMB30 million in turnover

What definitions are used for

Definitions must be flexible to fit different contexts and a constantly evolving environment

Government sometimes needs to segment businesses by size to prescribe which businesses should be included and excluded from a policy or intervention. The definition used needs to make it clear which businesses are to be targeted, and which are not. Where the line is drawn depends on the purpose of the policy or intervention being implemented, and can vary widely from situation to situation. Take the following two examples:

EXAMPLE 1: MBIE's Emergency Business Support Policy Framework recommends financial support for businesses with fewer than 20 employees in cases where those businesses can demonstrate that they have suffered a substantial drop in revenue due to a sudden and sustained disruption, normally as a result of a natural disaster. The purpose of the policy is to support businesses that are an important part of the local and national economy and are too small to have the cash reserves necessary to survive the downturn in business, and ensure those businesses are able to continue to contribute to society, following a disaster event.

EXAMPLE 2: Inland Revenue requires all businesses with a turnover of $60,000 or more to register for GST, whereas GST registration is optional for those businesses with a lower turnover. The purpose of setting the cut-off at this level is because the compliance costs of registering for, and paying GST, would be disproportionately high for businesses with a turnover of less than $60,000.

In the above examples it is clear that MBIE and Inland Revenue have very different, but equally legitimate, methods of segmenting the business population by size. It is also clear that neither method of segmentation would be suitable in the other agency's context. That is to say, that emergency business support should not be provided only to businesses with a turnover of less than $60,000, and nor should GST registration only be mandatory for businesses with 20 or more employees.

While both of these examples may be appropriate methods of targeting certain segments of businesses, broader trends such as the rise of the gig economy also need to be considered to ensure that the definition used remains relevant through time. These examples illustrate why it is important that government has the flexibility to segment the business population on a case-by-case basis to ensure that interventions can be tailored to optimal effect.

Definitions are used to exclude

When the government segments businesses by size to target a particular policy or intervention, it is important that the definition enables both government and businesses to be certain of who is impacted.

[2] "Annual receipts" is different to turnover because it refers to all money that the company has received in a year. For example money from money gained from selling assets or taking a loan from the bank are both examples of receipts.

However, the need for certainty can lead to a situation where businesses that are excluded from the intervention are equally affected or disadvantaged by the problem or issue government is trying to address, but unequally treated by government's response.

For example, in the government's response to the 2016 Kaikōura Earthquake, emergency business support was provided to businesses that had fewer than 20 employees and could also demonstrate that they met a number of other criteria including financial viability and being geographically located in specific areas.

It soon became clear, however, that some businesses that did not meet all of the criteria to qualify for support had a strong case as to why they should be included. In this example, government showed flexibility by providing an opportunity for affected businesses that either had 20 or more employees or were located outside of the target regions to also apply for assistance.

The above example illustrates the importance of government taking the time to carefully consider the impacts of a policy or intervention, and ensure that businesses outside of the segmented population are not inappropriately excluded.

As reflected in our recommendations, the Small Business Council's view is that the government's default position should be as inclusive and flexible as possible when designing interventions that impact on small businesses, and ensure that any segmentation used is fit for purpose now, and in the future. To ensure affected businesses understand why the government is either including or excluding them, agencies should be transparent about the purpose of the segmentation and why they are using any specific definition of business.