

# The Context for Australian SME Exits

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## **ABSTRACT**

SMEs play a significant role in the Australian economy as they account for 95% of enterprises and 60-70% of jobs. The nature of SMEs are that there are many start-ups and almost as many failures each year. Whilst there have been significant studies on areas associated with business cessation, there has been very little research focus on business exits that do not include business cessation.

Of the 3,015,318 active businesses in operation on June 30, 2004 the vast majority (72.2%) were non-employing businesses i.e. owner only operated or legal entities established for non-trading purposes. The non-agriculture private sector consisted of 90.0% small business (1-19 employees), 9.4% of medium business (20-199 employees), and 0.6% large business (200+ employees).

The combination of *Business Exits Australia* and *Experimental Estimates, Entries and Exits of Business Entities* provides a foundation for understanding business exits related to harvest. Overlaying the range of outputs from both studies provides a spread from 1.0% to 2.3% with a benchmark harvest rate of 1.3%. Based on a June 30, 2004 population of 762,837 employing non-agricultural private enterprises, this provides a forecast of 9,917 owners who sold their businesses in that financial year and the annual value add of \$9.26 billion or an average of \$933,356 per business.

## **1. Introduction**

This paper forms part of the background discussion to a study on successful small medium enterprise (SME) exits in Australia. Its aim is to undertake an analysis of two prior studies on business exits. The focus of this analysis is to determine if it is possible to reconcile their results so to produce a common harvest rate for use in subsequent sections of this study.

SMEs play a significant role in the Australian economy; they account for 95% of enterprises and 60-70% of jobs (OECD 2000). The nature of SME operation in Australia is that there are many start-ups and almost as many failures each year. Significant studies (Peacock, 2000; Beddall Inquiry, 1990; Lowe et al., 1990; Price, 1984; Williams, 1987) have been completed on areas associated with business cessation (liquidation, insolvency etc.) because of the consequences associated with loss of jobs, social impacts, legal and regulatory issues, and possible flow on effects to other businesses and organisations. In comparison, very little research focus has been placed on business exits that do not include business cessation.

## **2. Counts on Australian Businesses**

A start point for any discussion on the exits begins with a counts on Australian businesses. Counts on the population of Australian businesses can be obtained from a range of qualified sources. Three principal sources are the Australian Bureau of Statistics (ABS), the Australian Tax Office (ATO), and the Australian Securities and Investment Commission (ASIC) [ABS 2005A]. Irrespective of the source, making accurate counts is a complex task that is very much dependent upon the definitions and inclusions / exclusions of entities considered in the

count. As a result, counts on businesses can vary significantly; at June 30, 2004 this ranged from a high of 5.2 million<sup>1</sup> to a low of 1.4 million<sup>2</sup>.

A good starting point for any defined count is the *Australian Business Register* (ABR) which is a whole-of-government register of Australian Business Numbers (ABN) maintained by the ATO. All businesses with annual turnovers in excess of \$50,000 and not-for-profit organisations with turnover in excess of \$100,000, are required to register for an ABN and remit *Goods and Services Taxes* (GST) to the ATO (ABS, 2005A). In some instances, separate businesses with related ownership may operate under a single ABN and in other cases; multiple commercial activities may be registered as separate ABNs. For these situations, the ABS maintains a 'population' (ABSMP – ABS Managed Population) for businesses where the ABN unit count is not suitable. This population comprises of typically large, complex, and diverse businesses. A correlation of the ATO 'population' (ATOMP – ATO Managed Population) i.e. GST paying businesses, and the ABSMP, provides a foundation for a valid count on active Australian businesses.

The June 30, 2004 Australian Bureau of Statistics count of Australian businesses reported that there were 3,015,318 active private and public businesses (ABS, 2005A and ABS, 2005B). This count excluded businesses without ABNs, general government, the central bank, non-profit institutions serving households, charitable institutions, social and sporting clubs, trade unions and other associations, unincorporated entities, diplomatic or trade missions, and foreign governments. An exclusion of businesses without ABNs, i.e. with turnovers <\$50,000, is numerically significant; however, for the purposes of this analysis, where counts of non-employing businesses are generally excluded, this will also eliminate almost all non-employing businesses. Accessing readily available and reliable data on activities of very

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<sup>1</sup> Cumulative count of records on the Australian Business Register (ABS, 2005A).

<sup>2</sup> ASCIC's record of registered companies (ABS, 2005A).

small non-employing businesses and family-owned agriculture businesses is problematical. The ABS study of *Business Exits Australia* (1997)<sup>3</sup> [*Business Exits*] bypasses this issue by analysing only employing, non-agriculture, and non-government enterprises. A subsequent study (ABS, 2005C) study *Experimental Estimates, Entries and Exits of Business Entities (Experimental Estimates)* also eliminates non-ABN enterprises coupled

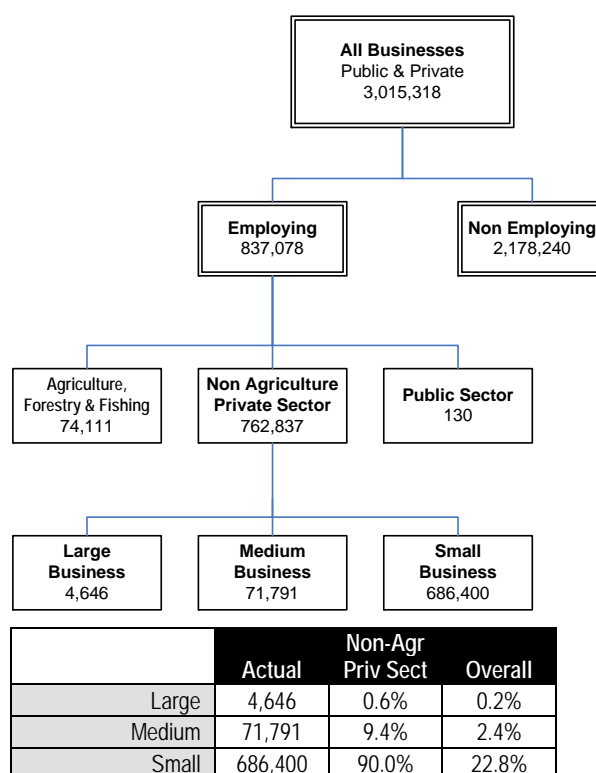


Figure 1 Source Adapted: ABS 2005A & ABS 2005B

with taxation activity / inactivity in its count of businesses.

This analysis on business exits attempts to reconcile these studies in order to provide a definitive count on SME exits; in particular, businesses that go to harvest. The *Business Exits* (ABS, 1997) study provides the most constraining criteria and therefore provides the framework to reconcile other business counts.

Of the 3,015,318 active businesses in operation on June 30 2004 (ABS, 2005B) the vast majority (72.2%) were non-employing businesses i.e. owner only operated or legal entities (trusts, corporate shells, etc.) established for non-trading and structural purposes. Of the 837,078 employing enterprises, 130 were public enterprises i.e. government owned, and 74,111 were involved in agriculture, forestry and fishing. The non-agriculture private sector consisted of 90.0% small business (1-19 employees), 9.4% of medium business (20-199 employees), and 0.6% large business (200+ employees) [ABS, 2005B].

<sup>3</sup> Precedes the introduction of ABNs which coincided with the introduction of the GST in Australia.

### 3. Business Exits

There is very limited data available on business exits in Australia (ABS, 1997). The most common and available

information from sources such as the Department of Attorney

|                        | 94-95 | 95-96 | 01-02 | 02-03 | 03-04 |
|------------------------|-------|-------|-------|-------|-------|
| Business Exits         | 7.2%  | 8.0%  |       |       |       |
| Experimental Estimates |       |       | 11.4% | 4.3%  | 4.1%  |

Figure 2 Source Adapted: ABS, 1997 & ABS, 2005C

General and ASIC, is usually

associated with measures on business failure and bankruptcy. Even this data provides only partial insight into business failure because it often does not cover events such as voluntary closures and forced sales which do not result in bankruptcy proceedings (ABS, 1997 and Bickerdyke et al., 2000). In order to identify rates of business exits due to changes in ownership / mergers (often referred to as ‘harvest’) it is necessary to remove data associated with business failure (forced or voluntary). To date, the most in-depth analyses of business exits have been *Business Exits Australia* (ABS, 1997) and *Experimental Estimates, Entries and Exits of Business Entities* (ABS, 2005C).

The findings from these studies ostensibly reveal similar exit rates; *Business Exits* (ABS, 1997) reports an average exit rate of 7.6% and *Experimental Estimates* (ABS, 2005C) reports an average exit of 6.6%. If the abnormally high 2001-2002<sup>4</sup> rate is removed from *Experimental Estimates* (ABS, 2005C) the ‘adjusted’ rate becomes 4.2% and is more attune with a normal year’s activity. Even allowing for survey and sampling errors there is now a sizeable disparity in exit rates. Other than the obvious timing differences, these results are drawn from studies that varied considerably in their methodologies, their sources, and their scope. Is it possible to reconcile these findings?

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<sup>4</sup> Exit rate for 2001-02 was abnormally high due adjustments to ABN registrations for the introduction of the GST and associated tax legislation.

### 3.1 Experimental Estimates

*Experimental Estimates* (ABS, 2005C) studied entries and exits of businesses based on the ATO maintained Australian Business Register (ABR). The key unit of data in the ABR is the ABN (Australian Business Number) which is discrete and unique to each business entity. All businesses with turnover above the GST threshold<sup>5</sup> are required to register for an ABN by the ATO. Businesses with turnovers below this threshold may voluntarily register for an ABN. All businesses without ABNs i.e. non-trading and not registered, have been excluded from this study. Utilising the counts of ABNs with records on tax activity provides the key basis for determining business entries and exits.

The final year of the *Experimental Estimates* (ABS, 2005C) study coincides with another ABS study, *ABS Business Register- Counts of Australian Businesses* (ABS, 2005B). By combining counts from both studies for the year ending June 30, 2004, it is possible to attain a better degree of alignment between the findings of *Experimental Estimates* (ABS, 2005C) with *Business Exits* (ABS, 1997).

*Experimental Estimates* (ABS, 2005C) start point is a stated population of 3,388,166 at June 30, 2004 (ABS, 2005C) which aligns with the ABS reported count (3,015,318 discrete entities) of Australian private and public businesses (ABS, 2005B). This 11% differential can be mostly attributed to the different methodologies used in the count, the difference being that *Experimental Estimates* does not account for complex and diverse businesses utilising multiple ABNs<sup>6</sup>.

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<sup>5</sup> GST threshold for not-for-profit entities is \$100K and \$50K for all others.

<sup>6</sup> Also confirmed by *A Statistical View of Counts of Businesses in Australia* (ABS, 2005).

Combining data from these two ‘aligned’ sources results in adjustments for agriculture, forestry and fishing; for government enterprises; and non-employing enterprises. The net result is an adjusted exit rate of 2.24% for the non-agriculture private sector. This represents a widening of differences but if the overall population is then

| Category                                       | Overall Count | Exit Count |
|--|---------------|------------|
| June 30, 2004 Population <sup>(A)</sup>        | 3,388,166     | 128,139    |
| Less Agric., forestry & fishing <sup>(A)</sup> | (271,473)     | (12,969)   |
| Less government enterprises <sup>(B)</sup>     | (130)         | -          |
| Less non employing enterp. <sup>(A)</sup>      | (2,103,411)   | (92,484)   |
| Adjusted Totals                                | 1,013,152     | 22,686     |
| Adjusted Rate                                  |               | 2.24%      |

Figure 3 Source Adapted: ABS 2005A & ABS 2005B

- (A) Source *Experimental Estimates, Entries and Exits of Business Entities* (ABS, 2005B).  
 (B) Source *ABR – Counts of Businesses* (ABS, 2005B). It is assumed that the exit rate for Government enterprises is nil. Even if all Government enterprises were included this would only adjust the overall exit rate by 0.01%.

adjusted for multiple ABNs (reduce the starting point by 372,848 [difference between 3,388,166 and 3,015,318]) this would provide an adjusted exit rate of 3.54%. By definition, exit rates involve two types of exits; business harvest (changes in ownership) and business failure or cessation. Since the purpose of this analysis is to identify the number of businesses which were harvested it is necessary to remove all data from this exit rate associated with business failure.

A 1996 longitudinal study on small business failures (Watson and Everet) identified two types of failures; insolvent failures which were typically liquidations and bankruptcies, and solvent failures which were voluntary closures where enterprises were solvent but owners were unwilling to make further losses or unwilling to continue because of non-financial business reasons e.g. commitment, stress etc. According to Watson and Everet (1996) for every three registered failures there is another one closure that can be classified as a solvent failure (28%). For the period July 1, 2003 till June 30, 2004, the Australian Securities and Investment Commission reported 11,008 insolvency appointments, i.e. companies that voluntarily appoint a liquidator or have a court appointed liquidator (ASIC, 2006A & ASIC 2006B). Applying Watson and Everet’s findings (1996) to the ASIC data provides us with an

estimate on business failure (insolvent and solvent) of 15,289 enterprises for the year ending June 30, 2004. If we now deduct this from the adjusted overall exit count of 22,686, this identifies that 7,397 enterprises were harvested; a rate of 1.15% of private sector non-agriculture businesses. The ASIC data on insolvency (ASIC, 2006A and ASIC, 2006B) may contain overlapping counts for non-employing enterprises and enterprises from agriculture and forestry. Therefore, within the bounds of non-sampling error, this rate of 1.15% should be considered a forecast at the lower end of harvest rates as it includes counts for agriculture and forestry which had previously been excluded.

### **3.2 Business Exits**

*Business Exits* (ABS, 1997) examined the rates at which firms exit the business population by studying responses to surveys on Fixed Capital Expenditure and Stocks and Sales for the periods 1994-95 and 1995-96. The scope of the study was non-government employing businesses but excluded businesses operating in agriculture, forestry and fishing. Exits were categorised into two groups: changes in ownership and business cessation. Changes in ownership included all businesses that were sold, taken over or merged; and cessations were businesses that ceased or closed, were liquidated or in receivership, or businesses that were untraceable, or the reasons for their exit were unknown. Up to 20% of the sample population exits were not traceable and as a result were assumed to be cessations.



| Type of Exit                      | Number of Business Exits |               | Exit Rates (%) |            |            |
|-----------------------------------|--------------------------|---------------|----------------|------------|------------|
|                                   | 94-95                    | 95-96         | 94-95          | 95-96      | Average    |
| Changes in ownership              |                          |               |                |            |            |
| Sold                              | 4,393                    | 5,324         | 1.2            | 1.2        | 1.2        |
| Takeover                          | 1,739                    | 1,426         | 0.5            | 0.3        | 0.4        |
| <i>Total Changes in Ownership</i> | 6,133                    | 6,750         | 1.7            | 1.6        | 1.6        |
| Cessations                        |                          |               |                |            |            |
| Ceased                            | 14,036                   | 19,020        | 3.8            | 4.4        | 4.2        |
| Liquidation / Receiverships       | 1,140                    | 521           | 0.3            | 0.1        | 0.2        |
| Unknown                           | 490                      | 157           | 0.1            | 0.0        | 0.1        |
| Untraceable                       | 4,436                    | 7,710         | 1.2            | 1.8        | 1.5        |
| <i>Total Cessations</i>           | 20,102                   | 27,408        | 5.5            | 6.4        | 5.9        |
| <b>Total Exits</b>                | <b>26,234</b>            | <b>34,158</b> | <b>7.2</b>     | <b>8.0</b> | <b>7.6</b> |

Figure 4 Source Adapted: ABS, 1997

From a total sample of 60,392 surveys over the two years, the study estimated that the overall exit rate was 7.6% of which 5.9% involved business cessations and 1.6% involved changes in ownership (ABS, 1997). Over one in five exits (20.1%) were not traceable by those conducting the study and subsequently these were all categorised as business cessations rather than proportioned over the two groups. As acknowledged by the authors, this slightly overstates cessations and equally, understates changes in ownership. If they were proportioned according to the pre-existing distribution this would produce 'adjusted' rates of 5.6% and 2.0% for business cessations and changes in ownership respectively.

One of the key findings of this study was the higher exit rate (7.7%) by small business (1-19 employees) than medium and large businesses (20+ employees) which had an overall exit rate of only 5.4% (ABS, 1997). Medium and large businesses tended to fail at a rate almost half (49.2%) that of small business (3.0% cessation rate versus 6.1% for small business) and if an exit were to occur there was a better than 45% chance of that being a business harvest rather than the alternative, business failure. By comparison, this was more than double that of small

business (20.8%). Medium and large businesses also had a 56.3% better harvest rate than their small business counterparts (2.5% versus 1.6%).

| Age of Business             | Number of Business Exits |               | Exit Rates (%)  |            |            |
|-----------------------------|--------------------------|---------------|-----------------|------------|------------|
|                             | Change In Owner          | Cessation     | Change In Owner | Cessation  | Total      |
| Less than 2 years old       | 2,510                    | 9,184         | 2.1             | 7.4        | 9.5        |
| 2 to less than 5 years old  | 1,908                    | 6,999         | 1.5             | 5.7        | 7.2        |
| 5 to less than 10 years old | 1,390                    | 4,899         | 1.6             | 5.6        | 7.2        |
| 10 or more years old        | 633                      | 2,673         | 0.9             | 4.0        | 4.9        |
| <b>Total</b>                | <b>6,441</b>             | <b>23,755</b> | <b>1.6</b>      | <b>5.9</b> | <b>7.6</b> |

Figure 5 Source Adapted: ABS, 1997

Overall the rate of exit for younger businesses was higher than the overall average. This was applicable for both business cessation (7.4% versus 5.9%) and changes in ownership (2.1% versus 1.6%). One of the explanations for this with regard to business harvest is that as businesses grow, some owners are not able to fund their growth and are subsequently forced to divest (Legge and Hindle, 2004; Gaujers et al., 1999; Stevenson et al., 1994). Another explanation is that after the initial ‘excitement’ of start-up, some owners discover that they are less interested in operating their businesses than first envisaged because of issues like loss of commitment, lower than forecast profitability, increased stress, family related issues, and drains on personal finance (Schaper, and Volery, 2004; Legge and Hindle, 2004; Flamholtz 1990; Gaujers et al., 1999). Bickerdyke et al. (2000, p.19)<sup>7</sup> attribute this to smaller businesses being more owner dependent and when the owner-operator dies, becomes sick, or seeks a lifestyle change, “business cessation is the likely outcome”. Larger businesses are more likely to be owner diversified and therefore less dependent upon a single individual. More mature businesses are more likely to have gone through these phases and as a result, businesses which have been in operation from two to ten years, tend to have exit rates more in line with

<sup>7</sup> Bickerdyke, Lattimore and Madge (2000) used a combination of the ABS (1997) study on *Business Exits Australia* combined with data on business-related bankruptcies published by the Inspector-General in Bankruptcy and data on company liquidations published by ASIC.

the overall averages. The ABS (1997) study found that more than 90% of exits due to changes in ownership can be attributed to businesses less than 10 years old. Bickerdyke et al. (2000) examined whether exit rates were a function of size or age with the general appreciation that younger businesses tended to be smaller and mature businesses larger. They concluded that exit rates were correlated to size rather age. The explanation for the lower exit rates of larger business was that larger businesses had lower transactional costs than their smaller counterparts and this enabled them to reorganise (downsize, restructure, etc.) rather than exit (Bickerdyke et al., 2000, p.21).

Once they exceed ten years however, they tended to have a lower than average exit rate. An explanation for this is that mature businesses can become 'cash cows' with a regular flow of profits to their owners so they are reluctant to sell out. The presence of professional managers in mature larger businesses also allow owner operators to pursue a chosen lifestyle without disposing of their business. To some SME business owners the business is not just a source of funds but it may also represent a desired lifestyle. Being one's own boss and being able to choose when and how hard they work is attractive to some owners and this is achieved more often in mature businesses. Once owners have established this lifestyle they are often reluctant to give this up.

#### 4. Discussion and Conclusions

The combination of *Business Exits Australia* (ABS, 1997) and *Experimental Estimates*,

|                        | Rate Rptd | Rate Adj | Error | Lower Range | Upper Range |
|------------------------|-----------|----------|-------|-------------|-------------|
| Business Exits         | 1.6%      | 2.0%     | 8.4%  | 1.3%        | 2.3%        |
| Experimental Estimates |           | 1.15%    | 5.0%  | 1.0%        | 1.3%        |

Figure 6 Source Adapted: ABS, 1997 & ABS, 2005B

*Entries and Exits of Business Entities* (ABS, 2005B) provides a foundation for understanding business exits related to harvest (changes in ownership). Taking into account its reported standard error, *Business Exits* reports a harvest rate range, with a 95%<sup>8</sup> surety, of 1.3% to 1.9%. If all ‘untraceable’ responses are not placed into the ‘cessations’ category and are ignored or dispersed proportionally, the harvest range is adjusted upwards to 1.7% to 2.3%<sup>9</sup>. Whilst *Experimental Estimates* acknowledges the difficulty in quantifying ‘non-sampling error’ (p.36), for the purposes of this analysis, a 5%<sup>10</sup> standard error is adopted. Applying this error and the same logic as for *Business Exits* to the calculated *Experimental Estimates* harvest rate<sup>11</sup> of 1.15%, provides a harvest range of 1.0% to 1.3%. Overlaying the range of outputs from both studies provides a spread from 1.0% to 2.3% with an overlap at 1.3%. Whilst it may be more accurate to provide an operating range to which businesses are harvested, the purpose of this analysis was to determine if it was possible to derive a single rate which was supported by the results *Business Exits* and *Experimental Estimates* studies and be able to used as a benchmark for ongoing analysis. It is concluded that a benchmark harvest rate of 1.3% fulfils this criteria.

Based on a June 30, 2004 population of 762,837 employing non-agricultural private enterprises this would forecast that approximately 9,917 owners sold their businesses in that financial year. This compares favourably with the 1995-1996 *Business Exits* count of 6,750

<sup>8</sup> Standard error stated as 8.4% for sample (ABS, 1997, p.3).

<sup>9</sup> Apply the 8.4% standard error to the adjusted exit rate of 2.0%.

<sup>10</sup> As used in ABS publication *Business Operations and Industry Performance Australia* (2002) p.36.

<sup>11</sup> Derived by subtracting the calculated number of liquidations from the published exit rate.

businesses allowing for a 3.5% annual growth in business counts for the period 1996 to 2004<sup>12</sup>. Utilising a similar methodology to the Bickerdyke et al. (2000) study but adjusting for CPI<sup>13</sup>, the annual value added for these exits is estimated to be \$9.26 billion or an average of \$933,356 per business.

The definition of an exit in both *Business Exits* and *Experimental Estimates* are clearly defined but neither study takes into account three distinct scenarios which would impact on any counts on business harvest and business cessation. The first scenario is where there is a change in business ownership due to imminent business failure. In this case the change in ownership is counted as a harvest but without the benefits of timing, this should be considered as a business cessation. The overall result would increase the count and hence the rate, for changes in ownership and conversely, reduce it for cessation.

The second scenario is that in many cases where there is a change in ownership, the old corporate entity will be voluntarily closed / liquidated. This is undertaken to reduce the risk of prior operation (litigation, warranties etc.) and can be executed by either the old or new owner depending on whether the shares in the entity are sold as part of the change in ownership or whether just the business assets are sold. This deregistering of the associated ABN attached to the entity's records as a business cessation but in this case, it is actually associated with a business harvest. Removing non-employing ABNs from the count may account for some potential errors in cessations (in situations where deregistration occurs across financial years) but misses the change in ownership. The overall effect is to again

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<sup>12</sup> In the period 1983-84 to 2000-01 the ABS reported that small business numbers had an average annual increase of 3.5% and medium / large businesses grew at annual rate of 3.3% (ABS 2001)

<sup>13</sup> CPI (Consumer Price Index). Bickerdyke et al. (2000) used data from *A Portrait of Australian Business* (IC and DIST, 1997) which attributes average value add of \$176K and \$5,784K for small and larger businesses respectively. This is then adjusted for annual CPI of 3% for the period 1997 to 2004. Assumed that 9,917 businesses are proportioned according to the actual population of small business (90%) versus medium / large businesses (10%).

increase the count and hence the rate, for changes in ownership and conversely, reduce it for cessation.

Business cessation is associated with business failure. In the third scenario some owners choose to close the business down by voluntarily liquidating it because they cannot sell the business or choose not to sell it. This is often the case in smaller businesses without large numbers of employees and where the business is very much owner / operator dependent. In these cases it could be argued that by voluntarily closing a business and freeing up capital and assets which are required to operate the business, the owner is actually undertaking a form of business harvest. Again, this error is diminished by removing non-employing ABNs from the count but the net effect is an increase in the change of ownership count.

The overall impact of these three outcomes is anticipated to result in a significant increase in the harvest rate but this would only be confirmed by a further empirical based study with these scenarios predefined as described above. Therefore, the stated harvest rate of 1.3% is considered to be conservative.

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