

P&SM: Use of Small Suppliers



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Introduction

The CIPS' practice documents are written as a statement in time. They are a collection of views on good practice within a particular subject area and are intended to provide direction on good practice with some guidance for context and interest. The reader is encouraged to use the CIPS practice documents for their own purposes, such as writing policy statements, guidance or procedures. This particular practice statement has been written primarily for the benefit of full-time purchasing and supply management professionals, but can be used by anyone associated with, or interested in, purchasing and supply management (P&SM).

This document is about the use of small and medium sized enterprises (SMEs).

Definition

CIPS recognises that there are several definitions of SME organisations available from sources such as the UK Government, EU and the CBI. For the purposes of this document, CIPS will employ the following definition of an SME organisation:

“An SME organisation is one with up to 250 employees and a turnover of up to £43m”

The European Commission¹ has determined that the main factors determining whether a company is an SME are:

- number of employees and
- either turnover or balance sheet total

Company category	Employees	Turnover	or	Balance sheet total
Medium-sized	< 250	≤ € 50 m		≤ € 43 m
Small	< 50	≤ € 10 m		≤ € 10 m
Micro	< 10	≤ € 2 m		≤ € 2 m

These ceilings apply to the figures for individual firms only. A firm which is part of a larger grouping may need to include employee/turnover/balance sheet data from that grouping too.

[the test to find out if you are an SME](#)

However, CIPS acknowledges that there is no single measure which will enable the concept of an SME to be usefully reduced to numbers; simply considering numbers can be unhelpful because there is a temptation to overlook other potentially crucial differences between companies which may be far more important.

For example, a firm near the top end of a typical SME scale of 250 employees has much in common with large firms and will be significantly different to, and will have different concerns and issues than, very small suppliers. Equally, the term ‘micro-business’ has been coined to describe organisations with approximately five employees and turnover of up to £250k and these will again be run very differently to a lot of other SMEs. Therefore, this document should be interpreted with some measure of flexibility depending on the scale of the organisation.

¹ www: http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm, last accessed 07/11/12

In addition to commercial organisations, CIPS notes that there are also social enterprises and voluntary organisations to which many of the points in this document will apply equally.

Background

SME suppliers perform a key function within the business community and within the economy as a whole:

- In total number, they employ more people than large organisations
- They can be fruitful sources of innovation
- A proportion of them will later develop into the large multinational organisations of tomorrow, such as Microsoft.

Explanation

Characteristics of SMEs

SMEs take a great many forms, and CIPS believes that P&SM professionals should always analyse a supplier's characteristics as much as possible before entering into a relationship. Some common characteristics are:

Market Share

SME businesses tend not to have a large market share unless they have a very specialist or niche offering, eg. software. Indeed, P&SM professionals in larger organisations have traditionally employed small firms on the basis that they have offered a 'niche' product or service ie. one that is not readily available elsewhere or one that is unique in quality or characteristics.

Composition

Some small organisations, especially those in service sectors such as management consultancy and IT, are virtual organisations with no head office or premises. Others have a presence that forms the heart of a community employing many local people and doing business with other organisations in the area.

Target Markets

There is a wide variety in target markets for SMEs depending on the product or service offering. Some SMEs operate in the local economy selling to businesses or consumers in a relatively small geographical area; some even have a small number of customers, or even one major customer, such as some specialist SME suppliers to manufacturing industries. However, it is also important to recognise that a considerable number of SMEs are not limited by geography, selling services and products on a national and often global basis.

Many SMEs, particularly those towards the smaller end of the scale, tend not to employ specialists outside of their core business specialism; rarely is there a professionally qualified P&SM manager or HR manager in a small organisation. Instead, one individual will be responsible for a range of functions, for example, purchasing, stores, production and accounts payable whilst another might be responsible for marketing, sales, customer relationship management and outbound logistics. Often in service SMEs the professionals who are

delivering services to clients are also running the company, marketing and selling and completing bids and proposals.

The implication of this for P&SM professionals liaising with small organisations is that it is not unusual to find managers in SMEs suffering from a lack of time, administrative resource and specialist expertise. This may mean that they may not be able to achieve industry standards such as ISO9000, which are often one of a buyer's criteria for supplier selection.

CIPS encourages P&SM professionals to work with small firms to help to develop their supply chain management expertise as part of a supplier development programme (CIPS positions on practice for supplier development are also available on this site). However, serious consideration of suitable suppliers should be undertaken before any planned strategic corporate development programmes are put in place; ideally this should form part of a properly planned and managed supplier relationship management programme.

Financial Backing

SMEs tend to be independent, privately-run organisations and this, coupled with relatively small turnovers, has tended to make P&SM professionals perceive them as a fairly risky option compared to a larger firm offering a similar product or service. This has been compounded by the fact that private firms tend to be less transparent about their profitability and financial standing.

Sometimes small businesses have a parent company or some other means of financial support; in such a scenario CIPS would encourage P&SM professionals to obtain a parent company guarantee if they are committing substantial business to the small organisation. Another method would be to obtain a performance bond from the small organisation with the responsibility for funding a bond resting with the supplier.

However, it is also important to realise that being small can often reduce financial risk rather than increase it so P&SM professionals must consider each SME on its individual circumstances, business, current client base and funding rather than jump to the conclusion that small means financially risky. Entering into dialogue with SME suppliers is encouraged as this will give a more complete picture than examination of financial accounts in isolation.

Time Frame

Small firms are not necessarily newly formed firms. There are many different types of small organisations; some are new "start-up" organisations, many of which are created for a limited period. For example, to fulfil a specific purpose to launch a new pharmaceutical product. Others have very long histories, for example a small family firm could have been established over a century ago.

Length of trading time should also be examined when considering risk as a small company that has been in business for many years will often be less of a risk than a new company that is growing rapidly and may be funded by venture capital rather than turnover; the internet "bubble" of the 1990s gives us many examples of large IT companies going to the wall.

Cash Flow

P&SM professionals need to be aware of the importance of cash flow to small firms. They should ensure that they agree, and do not impose, suitable payment terms with SMEs and they should ensure that their organisation complies with these. Shorter than normal payment periods may be appropriate, as may stage payments, deposits or pump priming for certain projects.

In spite of Late Payment legislation, such as the Late Payment of Commercial Debts (Interest) Act 1998² in the UK, irresponsible organisations still postpone payment. CIPS believes that late payment, as distinct from withholding payment in the case of defective goods or other valid reasons, is unprofessional and is a practice that P&SM professionals should endeavour to rectify. In the UK organisations are required to pay SME suppliers in a maximum of 30 days from invoice date.

Economies of Scale

Small organisations do not have the benefit of economies of scale enjoyed by larger organisations and consequently their input costs can sometimes be higher, especially if their procurement is being undertaken in a non-professional manner. This is an obvious example of where P&SM professionals can help small firms by, for example, encouraging collaborative purchasing or even allowing suppliers access to their own supply contracts where the supplier is providing services to them so that mutual benefit is obtained, eg. travel and hotel arrangements for consultants (Competition law is unlikely to be a barrier here but its provisions should nonetheless be noted).

Capacity

The capacity of any firm to carry out a particular contractual requirement has always been a key concern of the P&SM profession. CIPS believes that SMEs are no worse positioned than any other organisation in respect of the buyer having to ascertain their capacity during a supplier appraisal process. As with any supplier appraisal process, the full capacity of the firm has to be determined, along with their current and expected commitments, in order to ensure that the spare capacity available for the contract can be determined. This may or may not be sufficient, but it is not necessarily a function of the size of the firm; a large company may well have insufficient spare capacity to meet the specific requirement at any one time.

Management

CIPS suggests that SMEs demand a closer working relationship with the customer, to the mutual benefit of both organisations. This is good contract management and should be undertaken irrespective of the size of the firm, but can often be neglected. P&SM professionals should be prepared to spend time with the SME, providing feedback and suggesting improvements.

² <http://www.legislation.gov.uk/ukpga/1998/20/contents>

Price

SMEs may not necessarily be the cheapest option despite their lower operating cost; this does depend on the type of business, for example SME consultancy companies may provide very experienced specialist resource which is not cheap, however, they will usually provide this at a lower mark-up or margin than large consultancies which reflects their lower operating costs.

SMEs may also add value in different ways. For example, they may offer an innovative product or an innovative business or contracting model. They may be prepared to be much more flexible than larger suppliers and often offer access to the senior decision makers much more easily. They may also be prepared to negotiate based on valuable references. If the selection decision is largely based on price, often SMEs would not necessarily win the business. CIPS encourages P&SM professionals to evaluate the whole value package when evaluating a supplier's offer, irrespective of their size, as CIPS believes too many purchasing decisions are too heavily based on up-front price alone.

Location

A common reason why P&SM professionals choose to work with SMEs is their links to their location. If the SME is local to the P&SM professional's organisation, it may well also provide cheaper transport costs and relationship management. SMEs in less local locations can also provide benefits, as they will often have links within the local community and provide knowledge of the local community that the P&SM professionals organisation will not have (CIPS position on practice for using local suppliers is also available on this site).

However it must also be understood that not all SME suppliers have target clients or markets in the immediate vicinity, with an increasing number having a national, international or global client base. It is therefore essential that P&SM professionals have a good understanding of their SME suppliers and the market in which they operate.

Benefits of dealing with SMEs

CIPS encourages P&SM professionals to have an open mind to engaging with SMEs. There are many benefits to be gained by placing business with SMEs, especially if they are niche suppliers; they often have excellent research and product development facilities which provide their competitive advantage and from which the purchasing organisation can also derive benefit. SMEs are generally more responsive to the value of the contract and this makes the buyer a preferred customer - the reverse of what is frequently the case in dealings with large firms.

Due to their size, SMEs have fewer customers and they are thus more inclined to provide a higher quality service and are more concerned about the risk of losing the business. This makes them more receptive to suggestions and improvements and often more willing to work with their customers on supplier development programmes. They are also better prepared to provide a more personal service, an important element in maximising competitive advantage.

SMEs have fewer staff and therefore shorter command structures; this makes communicating with their decision-makers much easier and it makes implementing change more straightforward. Further advantages of SMEs over their large company counterparts include innovation, flexibility/influencing, shorter lead times and logistic chains.

Being a key customer of an SME provides greater leverage than being a medium customer of a large supplier and may give benefits that overcome a possible cost difference. Additionally, although the direct costs of SMEs may be higher; this is often offset by a lower level of overhead.

Balancing Risks

A major element in procurement risk is the choice of supplier, and a key factor in this risk is the size of the supplier. All suppliers, of whatever size, carry risk, but the level of risk will vary depending upon the size of the supplier. There is a perception that large suppliers are less of a risk in some ways, such as financially, than smaller ones but this is not necessarily the case. While large companies perhaps experience less bankruptcy, this can be balanced by the fact that large companies are more inclined to reorganisation and rationalisation. Larger organisations are also more susceptible to mergers, acquisitions and take-overs. Equally, as was stated earlier in this document, smaller suppliers can often offer greater assurances about security of supply (CIPS position on practice on risk management is also available on this site).

CIPS encourages P&SM professionals, where it makes sense to do so, to enable SMEs to bid for larger pieces of business. 'Risk' is not synonymous with 'small' and many large organisations have unexpectedly gone into receivership or liquidation.

CIPS suggests that one way to test the ability of an SME to meet a requirement would be to dual-source in the first instance before moving, as appropriate, to a single-source or even partnering type relationship.

CIPS believes that P&SM professionals should be responsible when encouraging SMEs to grow and meet their needs.

CIPS recognises the importance of creating markets and developing suppliers so that they are able to meet a need that currently cannot be met within the marketplace. Equally, it is sometimes the case that partnerships, or even backward integration (buying the supplying organisation), are required to enable the smaller firm to move nearer to the customer. For example, this has been the case with some automotive manufacturers and other organisations which have implemented Japanese purchasing principles. In these circumstances CIPS believes P&SM professionals should undertake responsible contracting and engage in the supplier development process.

Responsible contracting includes ensuring that longer term business relationships in particular have appropriate exit strategies so that in no circumstances is an SME's (or indeed any size firm's) financial integrity damaged to such an extent that their business subsequently fails when the contract expires. CIPS recommends that P&SM professionals carefully evaluate, by means of a thorough assessment, the amount of a supplier's turnover their business represents.

There has been a trend in the past to state that the percentage of an organisation's business should not represent more than a defined percentage of a supplier's turnover. CIPS has chosen not to be prescriptive in this regard but advises P&SM professionals to understand the risks associated with awarding contracts that represent a high percentage of a suppliers business. Another aspect of good practice is to ensure that a risk analysis is undertaken if a supplier is dependent upon less than four key contracts.

In certain circumstances, such as specialist parts for the automotive industry, the buyer can make a conscious decision to buy 100% of an SME supplier's output, either directly or indirectly, via another supply chain partner. P&SM professionals need to be aware that when entering into this type of relationship there is a responsibility to manage any withdrawal from the relationship over a period of time to protect the supplier from enforced bankruptcy.

The UK Government recognises the importance of SMEs to the economy and the delivery of economic growth. In March 2011 the Government set a new target that 25% of spend with third party suppliers should go to SME's by 2015.³

Conclusion

SMEs play a more significant role in the business environment and the economy as a whole than is often realised. In the UK SMEs employ more people overall than large organisations. CIPS encourages P&SM professionals to avoid the concept of 'big is best' and analyse the options carefully so as to arrive at appropriate conclusions for their businesses.

P&SM professionals need to be aware of the benefits which can flow from entering into trading relationships with SMEs, including personal service, flexibility and innovative capacity. Smaller firms can also often supply goods and services which may not be readily available elsewhere or, if they are available, would involve long lead times or other forms of inconvenience. It is also important to be aware of the possible barriers to trading with SMEs and to be prepared to work with them to overcome these barriers. Small does not necessarily mean 'easy' or less work for the buyer.

³ WWW: <http://www.dwp.gov.uk/supplying-dwp/doing-business-with-dwp/small-and-medium-enterprises/>

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