ACCOUNTANCY EUROPE.

SME RISK MANAGEMENT INSOLVENCY

FACTSHEET

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HIGHLIGHTS

About 200,000 companies go bankrupt every year in Europe, resulting in 1.7 million job losses. The ongoing COVID-19 crisis and economic downturn has exceptionally worsened the situation, putting an unprecedently heavy strain on Europe's small and medium-sized businesses (SMEs). And the worst may yet be ahead, as governments will eventually end their current COVID support measures[1].

Financial distress and insolvency[2] are recurrent risks for small businesses. Entrepreneurs are the experts in running and managing their own business. But it is difficult especially for smaller companies to devote the resources to keep a check on all possible risks facing their business.

Accountants[3] can help the SME management to fulfil their responsibilities, ensure that the business is run in a sustainable way, and that the financials are in order and not indicating forthcoming issues.

This paper – part of our SME risk management project series – outlines some of the main insolvency risks and challenges faced by SMEs. We highlight the role that professional accountants can play in managing and preparing for the risks, identifying red flags to better advise their SME clients. It also includes two checklists to support the accountant in their work to mitigate their clients' insolvency risks.

WHAT CHALLENGES ARE SMES FACING?

Many SMEs face potential insolvency risks at some point in their lifecycle – especially in the early years. For example, according to Eurostat statistics less than half of new businesses in Europe were still in business after five years.

These risks are linked to situations that an SME may encounter when operating in competitive markets, for example:

- cash flow crisis caused by a large unforeseen expense, tax bill or a purchase
- loss of business from increased competition
- loss of an important customer
- unexpected drop in sales (or an inconsistent period of sales)
- key employees and management leaving or becoming ill

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[1] Accountancy Europe proposed in spring 2020 15 recommendations for governments to help SMEs in COVID times.

[2] Financial distress is a situation where a company's operating cash flows are insufficient to satisfy current obligations, whilst insolvency means the point when the company can no longer meet their financial obligations to lenders as debts become due. In this paper, 'insolvency risks' is used as a broader term encompassing both pre-insolvency (financial distress) and actual insolvency situations.

[3] This paper focuses on the role of SME accountants. The services described in this paper would not be allowed to be provided by an SME's auditor due to independence reasons.

- impact of regulatory changes
- overtrading, significant increase in business without sufficient capital
- inflation and bank interest rates
- lack of financial control and poor management information, particularly in the early years of the business
- fraud, especially combined with the point above

SMEs' financial distress and insolvency challenges can either develop over **medium to long-term** periods or be the result of **sudden unexpected crises**, such as the ongoing COVID-19 pandemic.

MEDIUM TO LONG-TERM CHALLENGES

A common reason for SMEs' insolvencies in Europe is ongoing company distress spanning over several years. Analysing the company's financial situation and balance sheet strength can often detect these issues. Discussing future orientated information such as budgets, cash flow forecasts and order books also helps.

Potential threats and risks should be identified as early as possible to address them effectively. In earlier phases, companies have a relatively wide range of options to adapt and address the situation. However, failing to identify and address the threatening risk can result in the business' distress intensifying even further, and available options shrinking. In later stages, the options will already be limited to a degree where it becomes extremely difficult to avoid a potential insolvency.

Some bad business practices can unwittingly increase the risk of medium to long-term financial distress and insolvency problems.

EXAMPLES

Poor record keeping and/or financial control

SME owner-managers who are busy creating and running their business may fail to capture and record vital data when required. Lack of good records in turn may lead to poor and inaccurate forecasting. And ensuing poor cash flow forecasts and budgeting exacerbate the problems. This is particularly dangerous in times of expansion, where focus is on sales rather than when the cash actually comes in. Overall, this will result in insufficient cash flow and lead to the inability to pay all creditors in time.

Inadequate internal controls

Lack of proper internal controls is another factor that may lead to trouble in the future. This is often linked with lack of resources or the perception that internal controls are mainly for larger and more complex businesses. Even in smaller businesses, inadequate controls may increase the risk of fraud, and the risk that costs and spending are not controlled in full by the company's management

Inappropriate funding for business operations

A failure to properly match funding with the company's assets can constitute another pitfall. Businesses should aim to ensure adequate funding both for current and long-term activities. Long-term assets should be matched to long-term financing, and only working capital should be financed from cash resources or overdraft.

Insufficient starting capital

Many new businesses start with insufficient capital as the entrepreneur may expect the company to flourish from early on. They may fail to consider potential losses in the initial growth period, while revenue can come with some delay.

SUDDEN UNEXPECTED RISKS

The SME's accountant (as will be seen below) plays a key supporting role in helping management avoid some of the above-mentioned pitfalls. But external megatrend events[4] can still take unexpected turns that put the business at great risk, despite all the best efforts to ensure a resilient and sustainable running of the business and its financials.

COVID's impact on SMEs

The COVID-19 crisis has shown how events beyond SMEs' and their accountants' control can threaten the survival of viable and otherwise successful businesses. The impact on the SME sector has been stark.

About 40% of SMEs in Europe report liquidity problems as a consequence of the COVID-19 crisis and measures taken to address it, according to SMEunited. And up to 50% of SMEs in the most affected sectors like hospitality, retail and construction have liquidity shortages. SMEunited also reports that SMEs are facing an increasing risk of becoming insolvent mostly due to increased debt ratios.

Business' resilience against unexpected risks can be improved by building layered reserves when times are good. These reserves should preferably be in liquid assets and constitute of:

- emergency funds
- short-term funds that can fund at least 6-8 weeks' operations
- longer term funds to cover long term plans and transitions[5]

Having reserves is not a guaranteed protection against financial distress or insolvency in times of unexpected shocks. But they provide a buffer and can make the difference between survival and bankruptcy during crisis times.

WHAT CAN ACCOUNTANTS DO TO HELP WITH SMES' INSOLVENCY RISKS?

The profession is strongest in assisting to prevent and mitigate insolvency risks before they materialise. On legal competence, the accountancy profession's formal involvement as insolvency practitioners in Europe is relatively limited. There are exceptions for specific countries such as Italy and the UK, where it plays a more prominent role.

Most SMEs in Europe have a professional accountant for services such as bookkeeping, financial management, filling tax returns and providing business advice. These day-to-day services already help SMEs avoid financial distress and prevent insolvency problems outlined in the previous section.

INVOLVEMENT STAGES

As an external and objective advisor, a professional accountant can help SME management to fulfil their responsibilities by supporting insolvency risks' prevention early on. For example by flagging any financial problems, supporting performance monitoring and advising their clients appropriately.

[4] Some of whose impacts on societies can be mitigated through policy-making that follows the advice of the scientific community

[5] For example adapting to climate change, investments in digitalisation in face of competition.

Prevention

Prevention remains the most effective way to mitigate insolvency risks. This is also where the accountancy profession is at its strongest. Professional accountants have the right background and expertise to help SMEs' management ensure that:

1. potential risks have been identified and assessed that may prevent the entity from continuing as a going concern
2. any proposed business plan is feasible and actionable, meaning that it aligns with monthly operating and cashflow budgets, and supported by robust forecasting
3. the business model can adapt to new circumstances (such as increasing online presence and online sales in times of COVID-19 lockdowns)
4. financial management is appropriate, and for example the impact of a potential loss of turnover is measured against the business costs
5. short term cash flow suffices and financial reserves are being prepared for possible future shocks
6. proper governance and decision-making are in place
7. communication, information flow and relationship with the businesses' lenders and banks go smoothly

Restructuring

The accountant can also monitor and help plan the restructuring process if things take a turn for the worse. Thanks to their financial experience and expertise, an accountant can plan a targeted restructuring process based on SMEs' specific needs and challenges.

Post-insolvency

If the insolvency has been completed, the accountant can assist the entrepreneur in restarting their business. This involves support such as preparing business and financial planning, cash forecasts and reorganising internal control processes. In complex cases, accountants can rely on their networks of contacts and direct the SME to dedicated corporate recovery services and business restructuring experts.

WHY ARE DATA AND RELIABLE ACCOUNTING SO IMPORTANT?

Appropriate and timely insolvency risk prevention and management come down to robust accounting, and the vital data that this provides. An SME is at risk of facing financial distress and insolvency issues when its key indicators and operating parameters show sudden, sometimes erratic variances, deteriorations and modifications. These also often impact one another in complex and vicious circles and sometimes in a very short timeframe.

The accountant and the SME managers require high quality information about the business that goes beyond mere historic information. This will allow them to identify potential trends that might lead to bigger problems if left unaddressed.

DATA INDICATORS FOR INSOLVENCY RISK IDENTIFICATION

Financial indicators and data analysis are of crucial importance, especially when compared to the average performance of peers in similar markets (sector and industry specific benchmarks).

For example Euler Hermes, an international leader in trade credit insurance, highlights three key indicators that can give warnings of SMEs' future financial distress and insolvency problems up to four years in advance, based on its research from four European countries (France, Germany, Italy and Spain):

- profitability: four years prior to an insolvency, the average return on capital employed (ROCE) can be relatively weak, somewhere between 0%-7%, whereas the overall average figure for SMEs and mid-caps is between 10-14%
- capitalisation: four years before their insolvency, SMEs can have lower than average equity ratios, ranging from 15,6% to 23,3%, whilst the average equity ratio of all SMEs and mid-caps is about 30%
- interest coverage[6]: up to three accounting years prior to an insolvency, SMEs' average EBIT-based interest coverage is very weak, ranging from 0.5x to 1,1x. The average interest coverage of all SMEs and mid-caps is about 3x.

Moreover, the European Commission's 2014 Communication on State aid for rescuing and restructuring non-financial undertakings in difficulty provides indications for what an undertaking in difficulty means. The criteria include that for two years, an undertaking's book debt to equity ratio has been greater than 7,5 and the EBITDA interest coverage ratio has been below 1,0.

Data management and analysis processes can be further improved with new technologies for data gathering, exploitation and visualisation. Historic information alone may not be useful, but technology can enable using real time accounting and banking information to develop algorithms to predict cash flow difficulties and pinch points.

DATA ANALYTICS FOR ACCOUNTANTS TO HELP SMES

No data-technology driven solution can fully replace the need for an accountant or advisor. Accountants' support will remain essential for SMEs' insolvency risk identification and mitigation, despite increasing automation and technological solutions for data gathering, exploitation and analysis.

Proper risk identification and assessment will still need the interpretation of a human advisor familiar with the business and its particularities – something the accountant will be well suited for.

This is because accountants already help clients with forward looking business planning and budgeting to mitigate insolvency risks. Accountancy practices also have the benefit of working with several SMEs, thus having holistic experience and benchmarks that meaningful data analysis for mitigating future insolvency problems requires.

If anything, the automation of mundane tasks (such as bookkeeping and tax reporting) and technology driven data analytics will free up time for accountants to provide more business advisory insights and services that aim for more proactive and explicit insolvency risk prevention.

According to a recent SMEunited poll, European SMEs' confidence is at an all-time low due to the COVID pandemic. SME owners will continue to rely on the insight and advice of its trusted advisors.

CHECKLISTS TO MITIGATE & IDENTIFY INSOLVENCY RISKS

These non-exhaustive checklists aim to support accountants' work at preventing and mitigating their SME clients' insolvency risks. They do not list all tasks that an accountant must perform or is responsible for, but rather areas where the accountant can support the SME managementt to make informed decisions that best suit their businesses.

[6] The interest coverage ratio measures how many times a company can cover its current interest payment with its available earnings.

Insolvency warning signs

FINANCIALS	**Negative operating cash flows** *As shown in historical or prospective financial information.*
	Equity below half of the share capital
	Ratio between turnover and break-even point at below 1
	Spiralling or sudden increase in expenditures
	Late payments from debtors or clients *Major customer or set of customers struggling to pay on time, especially if the SME is not sufficiently (or at all) covered by credit insurance.*
	Short-term changes in assets/liabilities *Significant increase in liabilities or decrease in assets over a period of 12 months.*
CREDITORS	**Increased information requests from creditors** *The SME's banks or creditors start asking more information than usual, and the pace of updating them on the businesses' key information increases. This may simply mean that the bank or creditor does not understand what is going on with the business at that moment, but could also be indicative of them seeing something they are not comfortable with and that could be indicative of upcoming troubles.*
	Delayed payments to creditors *Overdue or delayed tax and/or invoice payments, repayment of loans, dividend arrearages or a number of payments and liabilities becoming due in a short time period.*
	Inability to keep up with loan covenants *Inability to keep up with loan covenants is not only a potential symptom of underlying troubles but can lead to creditors requesting an immediate repayment of all receivables.*
	Weakened access to credit and financing *Denial of additional credit from suppliers, or lenders turning down loan requests.*
	Excessive reliance on short-term financing to cover long-term assets
BUSINESS FEATURES	**A declining business model** *Business model that is not ready for or convertible to a green and digital paradigm shift etc.*
	Mixing of personal and professional *Intermingling between professional and personal affairs of the management. This often starts small but may gradually evolve into serious situations such as someone defrauding professional activity for personal gain.*
	Weak financial literacy *Inadequate financial literacy of management. For example, this is sometimes seen with new entrepreneurs who have great business ideas but lack financial literacy.*
	Increased employee absence *Higher rate of illness or absence of employees, which may lead to lower output and income but with unchanged labour expenses.*
	Potential legal claims *Pending legal or regulatory proceedings against the SME that, if successful, may result in claims that the company is unable to cover.*
	Over-dependency on key staff *The SME's functioning is dependent on one or two key staff members whose departure or retirement from the company could pose a problem for business continuity. This includes over-dependence on the owner-manager.*
	Un- or underinsured catastrophes
SUPPLIERS & CUSTOMERS	**Decreasing credit limits from suppliers of goods and services** *Decreasing credit limits from the SMEs' suppliers, especially where the suppliers use credit insurance. When credit limits tend to go down, this could sometimes mean that the suppliers' credit insurers are anticipating issues. This is likely to lead to some suppliers requiring earlier payments.*
	Loss of a principal customer or supplier *Dependency on one or few principal customers and suppliers which increases the risks for the business if the customer or supplier is lost.*
	Change from credit to cash-on-delivery transactions with suppliers

Insolvency risk mitigation[1]

BUSINESS PROFILE	**Know your client**	Increase direct in-person communication to discuss with them regularly and provide personal advice [2].
	Managing assets	• ensure that assets are adequately accounted for and insured • identify any potential stranded assets • perform valuations of assets (property, plant, equipment) and monitor for events that may affect their value
	Stocks and warehouses	Advise the SME to: • move away from maintaining physical stocks and warehouses and • to rely instead on online order and delivery
	Digital business model	Where possible, advice and guide the SME to set up digital infrastructures for online marketing and sales.
ACCOUNTING & BUDGETING	**Accounting systems and organisation**	Ensure that the business has adequate organisational structure and systems in place for accounting and reporting, depending on the size of the business, number of employees etc.
	Accrual accounting	For larger SMEs, help transition from a cash accounting system to accrual accounting. It provides a more complete view of the business and assists with the management of assets and liabilities[3].
	Rolling forecasts	Help the SME management to: • conduct a rolling forecast on the business and • assess, for example, whether the company's financial reserves are sufficient under key risk scenarios
	Prudent forecasting	• assess whether the company is being sufficiently prudent in its forecasts and takes into account appropriate risks[4] • advise the business on forecasting for longer periods than the usual 12 months that is often required in law
	Measuring tools	Introduce measuring tools such as debtor days or days until full cash depletion if turnover were to cease. If such measurements are done regularly, the deterioration of a business can be spotted long before an actual cash flow crisis highlights it
	Peer benchmarking and data analysis	Help monitor the SME's Return on Capital Employed (ROCE), equity ratios and interest coverage for possible early signs of future problems, using the performance of businesses with a comparable profile and markets as an indicative benchmark.
FINANCIALS	**Late payments**	help monitor the SME's accounts receivables for any late payment risks or trends assess whether the business is dependent on a major customer or set of customers with a history of late payments.
	New debt	Advice the SME against incurring new debt or credit unless it is part of a turnaround plan that is reasonably likely to lead to a better outcome for the business.
	Financial reserves	Advice and help the SME build up and maintain financial reserves worth up to three times the monthly expenses of the business, where not already required by applicable legislation.
	Funding options	• keep yourself up-to-date on various public funding options (whether local, national, EU) available for the SME under different circumstances (general support and deductions, specific support for green or digital investments, crisis funding etc.) • familiarise yourself with the application conditions and documentation requirements, which can include for example new sustainability conditionalities • in case of support loans (rather than grants), pay attention to repayment rules and conditions as these may differ significantly between schemes

CREDITORS & INSURANCE			
		Build trust with creditors	Offer to liaise directly with the lenders and banks of the SME to ensure continuous, smooth communication and exchange of key information. This helps to establish a framework of trust and confidence between the two sides.
		Managing creditors	Identify creditors with whom trade terms have been breached and where renegotiation or alternative sources may be required.
		Insurance coverage	Check existing insurance agreements in place and discuss with management where additional insurance coverage could be appropriate.
		Trade credit insurance	Assess whether the SME could need trade credit insurance for main customers, and if justified on the basis of a risks, benefits and costs analysis. This way, if the SME's customers become insolvent or fall into protracted default, it is indemnified for the value of goods or services it has delivered up to the credit limit.
		Suppliers' credit insurance	Encourage the SME to ask their main suppliers (or former main suppliers) whether they use trade credit insurance for the goods or services that they deliver. If yes, enquire how the credit limit for the entity has evolved in the past years and months. As credit insurers use robust methodologies for their ratings, decreases of the credit limits or a 0 credit limit (credit insurer refusing to insure any non-payment, whatever its amount) are strong indicators of potential problems in the business.

[1] Not all the items will be relevant to all SMEs' sizes, sectors, business profiles etc.
[2] As digitalisation and automation free up time from standard book-keeping, reporting and tax filing work to enable an appropriate follow up.
[3] For most smallest and micro entities cash accounting remains sufficient and helpful
[4] As covered, notably, in other papers of Accountancy Europe's SME risk management project series