EUROPEAN FEDERATION OF ACCOUNTANTS AND AUDITORS FOR SMES

# THE ROLE OF EFAA AND OF SMPS IN EARLY WARNING FOR SMES

FEBRUARY 2021

BY

SALVADOR MARÍN, EFAA PRESIDENT
MORTEN MØLLER, COORDINATOR OF THE EARLY WARNING EUROPE NETWORK
PAUL THOMPSON, EFAA DIRECTOR

## WHAT IS EARLY WARNING?

The EU SME strategy stresses the need to promote entrepreneurship and the growth of SMEs across Europe. A key element is to create strong framework conditions for entrepreneurs and businesses across sectors that can help them face key challenges, including managing a crisis, dealing with bankruptcy, and getting a second chance. The COVID-19 pandemic and the resulting financial challenges it has posed businesses - SMEs have been disproportionately affected - has highlighted the urgent need to create and reinforce framework conditions.

Providing advice and support to companies in distress, or indeed preventive advice and support to companies even before they become distressed, can help prevent bankruptcies and their negative consequences such as job losses, increased economic risk for suppliers in the company's value chain, and a potential economic, social, and personal calamity for the company owners and their families.

Early intervention increases the likelihood of a turnaround of the company resulting in a stable economic situation for the company and even sustainable growth. Moreover, if a company in distress is closed down at an early stage of the crisis, the intervention can help avoid an unsurmountable debt for the company owner, thus giving him or her the chance to start a new venture (second chance).

The Early Warning Europe Network is an organisation that promotes and provides impartial, confidential assistance free of charge to companies in distress across Europe. The national operators of these assistance services rely on a strong stakeholder network for visibility and ambassadorship, and the SMPs in all countries hold a key role in alerting entrepreneurs to crisis signs and encouraging them to seek professional assistance from an Early Warning operator.

## WHAT IS THE ROLE OF SMALL- AND MEDIUM-SIZED ACCOUNTANCY PRACTICES (SMPS)?

### *Helping SMEs with Financial Management*

SMPs are often the accountants, assurance providers, tax advisers and trusted business advisors of SMEs and their owners. In this capacity SMPs gain a deep knowledge of their clients' business and in particular get well acquainted with the financial performance, position, and prospects of the business. This means they can be a key element of early warning. In addition, evidence suggests that SMEs, when they fail, usually do so due to a shortage of liquidity to meet their obligations and/or due to the absence of a medium and long-term strategy that adapts to their scale or size, rather than for lack of profit due to insufficient income. In other words, SMEs tend to fail due to lack of liquidity or application of the strategy appropriate to your size rather than them not being viable. Lack of liquidity and absence of an adequate ex ante strategy or control is often the consequence of poor financial management. SMPs can help SMEs improve their financial management and strategy/control, enhance their liquidity, and ensure their solvency and continuity.

### *Helping SMEs with Business Continuity*

In the wake of the economic crisis induced by COVID-19, many SMEs have turned to a trusted advisor, often an SMP, for help and guidance through this crisis. SMPs have a deep knowledge of their clients' business and many of the specialist skills necessary to help them navigate through these most challenging of times. In the early stages of the crisis, guidance was needed to access government grants and subsidies. Many businesses now face a prolonged period of changing circumstances (i.e. the "next normal") and continue to require assistance and sound advice. SMPs can help effectively manage and reduce risk, explain how to take appropriate actions, and fortify strengthen the business for the medium- to long-term. The Small Business Continuity Checklist is a diagnostic tool to navigate times of disruption, covering two key areas of Financial Management Tasks and Strategic Management Tasks. It is a tool to help SMEs, and their advisors, identify priority actions for immediate attention.

### *Helping SMEs Identify Early Warning Signs*

It is important for business owners to understand the risk factors for insolvency and act to mitigate the risk before it is too late. The biggest issue for businesses is that they ignore or do not recognise the warning signs, then leave any corrective action until it is too late. While it may be possible to turn a business around, the best approach is to avoid hitting that worst-case scenario through early intervention. Business owners, with help from specialists like an SMP, should monitor their businesses closely and, if they start to demonstrate any of the warning signs, take corrective action immediately. When trouble is detected early, a business has time to understand the underlying cause of the problems and explore options for recovery, including informal insolvency solutions and government support.

The table below sets out some early warning signs which SMEs (and the SMPs that advise them) should be looking out for. Data analytics can also be used to search for early warning signs from accounting data.

1. **Inadequate cash reserves** - businesses must first look to service their existing and ongoing debts and obligations. However, it is also important to have reserves in place to deal with unexpected events, fund-growth strategies, and leverage opportunities as they arise.
2. **Poor cash-flow management** - similarly, if the business fails to manage cash flow strategically, then otherwise unremarkable business events could become catastrophic. Such events can include losing a major customer, paying increased interest rates, or correcting ineffective control systems.
3. **Inability to access finance** - if a business cannot access finance, either because the banks deem it too risky or because the business is at the limit of its borrowing capacity, this can be a significant warning sign.
4. **Opaque reporting** - businesses that are at risk of insolvency may have difficult-to-understand or unnecessarily complex financial reports that do not clearly show where income or losses are coming from.
5. **Late payments** - businesses that are in distress often hold back payments, request extensions or emergency funding, or fail to pay invoices altogether. If the business is unable to

pay its obligations in full and on time, this should be cause for concern.

6. **Staffing issues** - if the business is experiencing excessive staff turnover and/or there are any issues with paying staff on time, this is another sign that cash flow either is not being managed well or that funds simply are not available.
7. **No clear business model** - if the business cannot clearly articulate who its customers are, how it makes money, and where future growth will come from, then it is unlikely to be well managed. Warning signs include not having an updated organisational chart, no succession planning or formal business planning, and ineffective or inexistent processes of performance management.
8. **Over-reliance on key people** - some businesses can thrive by relying on one or two key people, but this is also a risky strategy. If the key people cease to be available, it could result in the business becoming unable to operate. It is, therefore, advisable to structure the business so it does not rely too heavily on one or two linchpins.
9. **Lack of attention to market fluctuations** - if business managers are not paying careful attention to the landscape they are operating in, they can miss key opportunities and fail to keep up with the competition. Declining sales should be an early warning sign that something needs to change. If managers are not on top of these numbers, the business will be at risk.
10. **Reluctance to address issues** - if managers are reluctant to identify and address issues around business performance, then it will be difficult to maintain competitiveness. Managers need to address issues as they arise and, if necessary, enlist the help of specialised business advisors.

## WHAT IS EARLY WARNING EUROPE?

The Early Warning Europe (EWE) network is providing advice and support to European companies in distress. EWE focuses on:

- **Raising awareness on all levels** - The EWE Network incentivises European, national, regional, or local events to raise awareness on early warning, second chance and bankruptcy.
- **Encouraging networking at the European level** - The EWE Network organises events and workshops at the European level to facilitate interactions between stakeholders and to gather experts from all member states to discuss policy questions on early warning, second chance and bankruptcy.
- **Facilitating capacity building** - The EWE Network strengthens the capacity of public and private organisations in member states and candidate countries to facilitate the establishment of early-warning mechanisms.

The history of EWE is summarised here.

## WHAT IS EFAA'S ROLE IN EARLY WARNING?

- Promote and raise awareness of the role SMPs play in the financial management and business continuity of SMEs
- Promote and raise awareness of the role SMPs play in identifying early-warning signs
- Participate in and represent SMPs in the EWE network

## ABOUT THE AUTHORS

The authors are Salvador Marín, EFAA President, Morten Møller, Coordinator of the Early Warning Europe Network and Paul Thompson, EFAA Director.

## ABOUT EFAA

The European Federation of Accountants and Auditors for SMEs ("EFAA") represents accountants and auditors providing professional services primarily to small and medium-sized entities ("SMEs") both within the European Union and Europe as a whole. Constituents are mainly small practitioners ("SMPs"), including a significant number of sole practitioners. EFAA's members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, tax and business advice) to SMEs.

**CONTACT ADDRESS**

EFAA – European Federation of Accountants and Auditors for SMEs AISBL
4, Rue Jacques de Lalaing B-1040 Brussels, Belgium
T +32 2 736 88 86 I F +32 2 736 29 64 I secretariat@efaa.com
www.efaa.com I Twitter @EFAAforSMEs