SME RISK MANAGEMENT: SUSTAINABILITY

FACTSHEET

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HIGHLIGHTS

As the backbone of the European economy, SMEs are increasingly in the centre of the focus on sustainable transition.[1]

This is because the relationship between SMEs and sustainability is increasingly interdependent, and it is no longer possible to ignore the impact of sustainability discussions on SMEs' business and markets. The sustainable transition needs the involvement of SMEs, while long-term resilient SME success cannot be achieved without the integration of sustainability considerations into their business strategies.

Thinking about sustainability can feel overwhelming for many small businesses that deal with everyday challenges and business survival, especially given the current unprecedent COVID-19 crisis (see our publication COVID 19: 5 key steps for accountants to guide SMEs through the crisis). Yet, the pandemic has demonstrated the urgent need for more resilient and sustainable business practices and supply chains.

As SMEs' trusted advisors, professional accountants can play a key role in this vitally important area and help SME owner-managers to think about their potential sustainability risks, mitigate them and tap into opportunities that stem from the sustainable transition.

This paper – the second one in our SME risk management series – aims to explain how and why sustainability is important for SMEs. It will explore the opportunities and risks that small businesses are facing in this area, including risks from not embedding sustainability into their business models. It will then elaborate how their accountants can help them integrate sustainability into their business strategies and operations. The risks are multi-faceted and may emerge from not meeting the expectations of key stakeholders (consumers, regulators, business partners, banks etc.), having weaknesses in the supply chain, being over-reliant on certain scarce resources and more.

[1] Although frequently used interchangeably with anything 'green', sustainability is a broader concept that is usually defined as meeting the needs of the present without compromising the ability of future generations to meet their own needs. See for example: http://www.un-documents.net/ocf-02.htm

WHY SMEs MATTER FOR SUSTAINABILITY?

Without involving the SME sector, generating a meaningful and resilient sustainable transition of the economy will be impossible.

In the OECD area, SMEs constitute a large part of the economy and employment. They account for approximately 99% of all businesses, contribute to about 70% of total employment, and generate between 50% and 60% of value added.

Although some SMEs are already highly active in environmental, social and governance (ESG) issues, many others have not yet addressed them. This can be seen for example with ESG reporting, where in the Global Reporting Initiative's (GRI) Sustainability Disclosure Database only between 10 -15% of all the sustainability reports in 2017- 2018 came from SMEs – despite them being far more numerous than larger firms in purely quantitative terms. The reasons for this include SMEs' lack of:

- resources: most SMEs have a very lean management model with key staff and owner-managers having multiple roles in the day to day running of their business. They often lack the internal resources to plan for the medium to longer term and deal with such issues as sustainability.
- awareness among business owners and employees about sustainability's importance and potential impacts
- access to financing
- adequate skills and management developed practices
- information and skills on how to implement sustainability into the business
- possible mismatches between sustainability initiatives and other business initiatives
- regulatory requirements – although this may change soon as the European Commission is currently revising its non-financial reporting Directive (NFRD)

SMEs dealing with day to day business survival may not see the urgency of sustainability considerations for their business, unless this is an inherent part of their business model, products or services [2]. Others may be worried about climate change and sustainability issues but lack the knowledge and resources to deal with them.

WHY SUSTAINABILITY MATTERS FOR SMEs?

SMEs are increasingly exposed to potential risks of not factoring sustainability into their business planning, with globalisation, ever greater and complex supply chains, evolving stakeholder expectations and an accelerating climate crisis.

Ignoring sustainability can prove to be even costlier than adaptation, as societies and economies invest increasingly in the sustainable transition, and the expectation – and increasingly requirement – for more sustainable business practices and information from businesses grows.

[2] For example many innovative start-ups are more sensitive to sustainability issues, often embedding in their business model the economic impact of ethical behaviour, and consider them to be a part of their global value creation.

SUSTAINABILITY RISKS FOR SMEs

On top of the systemic, economic and societal threats for businesses (and livelihoods) that climate change will bring, some of the most immediate sustainability risks that SMEs may face include the following:

- **Outdated business model**: not actively assessing and considering the business' sustainability impacts (including production methods and delivery, access to raw materials etc.) may lead to an obsolete business model. This may not only mean less clients and fewer potential business partners, but also a weakened willingness among family businesses' next younger generation to continue running it. Not adapting to sustainability may also weaken the business' ultimate sale value for when a SME owner plans to sell their business in order to retire on the proceeds.
- **Losing out in competition:** companies of all sizes – including an increasing number of SMEs[3] - embrace and integrate sustainability factors in their business models, and innovate on sustainable solutions, services and products. Not getting involved or addressing this change may prove to be a competitive disadvantage for the business in the medium to long term. This is particularly an issue for consumer facing businesses.
- **Regulatory requirements:** as legislation becomes more focused on sustainability, businesses that do not adapt may have to adapt to new areas of sustainability legislation very fast, or otherwise risk breaching legislation which then leads to penalties, fines and reputational damage.
- **Non-regulatory requirements:** SMEs that are part of supply chains may face various sustainability requirements by larger companies in the chain[4] in areas such as business practices, data gathering and reporting. Same goes for similar requirements by public sector institutions when opening public procurement tenders and moving towards green public procurement.
- **Less access to finance:** SMEs may see weakened access to bank or equity financing. Many banks are already adopting sustainability criteria and issuing green loans. If this trend becomes more prevalent, bank financing may become increasingly conditional to providing proof of sustainability practices.
- **Stranded assets:** with climate change, extreme weather conditions and authorities establishing more restrictive limits for environmental emissions or setting up new natural protection areas, there is a risk that certain assets owned by the business become stranded[5] , thus converting into non-performing or even a liability.
- **Supply chain related risks:** scholars have began to look at potential supply chain sustainability risks for businesses. For example, Sutrisno et al. (2019) argue that businesses that are not aware of what is going on in their supply chains – either downstream or upstream – face 'unknown threats' from which significant problems may arise. The ongoing COVID-19 outbreak and its impact on supply chains and markets is yet another demonstration of why robust supply chain awareness and management matter.

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3 For example, according to the Eurobarometer already in 2016 three quarters of SME respondents had already undertaken some circular economy related activity. Even among the smallest businesses this number was 72% https://ec.europa.eu/COMMFrontOffice/publicopinion/index.cfm/Survey/getSurveyDetail/instruments/FLASH/yearFrom/1974/yearTo/2016/surveyKy/2110

4 As highlighted for example in GRI's 2018 report on sustainability reporting by SMEs: https://www.globalreporting.org/resourcelibrary/Empowering_small_business_Policy_recommendations.pdf

5 Stranded assets can be defined as assets that have suffered from unanticipated or premature write-downs, devaluations, or conversion to liabilities which can be caused by a variety of risks. See for example here: https://blogs.thomsonreuters.com/answerson/stranded-accounting-for-unused-assets/

SUSTAINABILITY OPPORTUNITIES FOR SMEs

Risk management is not only about the negatives, and can also consist of simply tapping into new opportunities that make the business more risk resilient overall. The above risks can entail opportunities too. SMEs tapping the sustainable transition's potential can allow (some opportunities are directly tied to the risks highlighted above):

- **Business expansion:** SMEs can expand their range of clients and services when complying with sustainability requirements or taking sustainability concerns into account. For example, by securing contracts with larger companies or winning public procurement tenders.
- **Cost reduction:** SMEs can reduce their business costs by introducing more sustainable ways of working and doing business. For example, the costs of investment in a new plant may be offset by increased energy efficiency, especially when grants are available to finance energy efficient assets.
- **Succession planning:** sustainability concerns may open the door for SME owners to consider the sensitive subject of their succession, and to make the next younger generation more interested to continue running the family business
- **Positive branding:** basing a business model around sustainability can improve brand loyalty, especially for consumer facing businesses. This not only attracts customers, but also strengthens employees' loyalty.
- **Attracting capital**: sustainability planning leads to a strong management structure, accounting system and internal controls to prevent financial harm. Reporting on sustainability also enhances the entity's corporate responsibility brand which may make it more attractive to lenders.
- **Long-term strategy**: considering sustainability moves a business towards longer term strategic planning, instead of focussing on short term results. This may also reinforce the business' ultimate sale value.

5-STEP PLAN FOR SUSTAINABILITY RISK MANAGEMENT IN SMEs

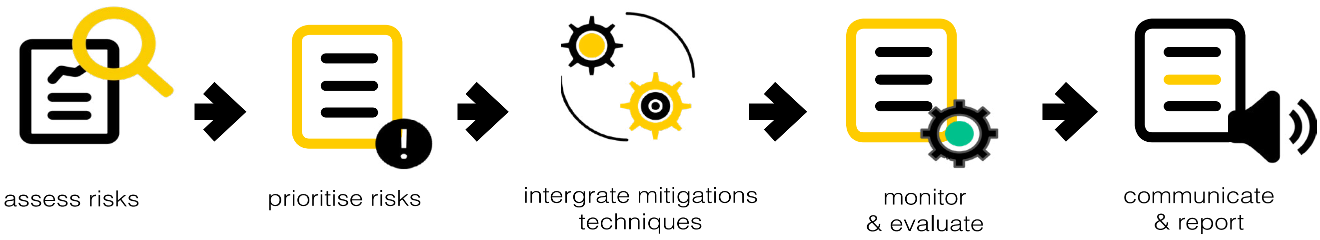
The purpose of risk management is not to eradicate all risks, but rather to enable taking the right risk for the right return (see our SME risk management project series cover paper). This requires:

- knowing the nature of potential risks affecting one's business
- being aware of the likelihood and possible impact of the risk materialising
- deciding what risks to focus mitigation on
- designing and executing the risk mitigation strategies

Based on these general principles, a robust sustainability risk management framework for SMEs consists of the following five key steps[6] :

1. perform a risk assessment by mapping your supply chain, business model and operations to identify potential sustainability risks and impact
2. prioritise the identified risks
3. take action to integrate risk mitigation techniques in business processes and where relevant, collaborate with supply chain partners to address risks
4. monitor progress and evaluate
5. communicate and report about your policies, activities, progress and metrics

[6] Based on the CSR risk management checklist produced by MVO Nederland – a network of entrepreneurs who work together on sustainability issues – and funded by the Dutch Ministry of Foreign Affairs: https://www.mvorisicochecker.nl/en/roadmap-csr-risk-management



Addressing these points in a consistent manner will require the involvement of different expertise and professionals. As highlighted by GRI, SMEs are unlikely to have in-house sustainability knowledge and expertise, which means they have to rely on external consultants – an often-costly enterprise. The SME accountant can play a cost-effective and crucial first line of defence role in many of these risk management steps.

WHAT CAN SME ACCOUNTANTS DO?

Accountants, as the trusted advisors for SMEs, have the reach and expertise to help their SME clients in sustainability risk management, notably because they:

- understand their clients' businesses' foundations, and are familiar with their key features, business model and financials
- have an ongoing professional relationship which is built on trust and integrity
- have experience with advising similar SMEs in an impartial, understandable and cost-effective manner

SME accountants that wish to provide enhanced sustainability risk management services can combine their conventional SME advice skills with new sustainability expertise. A good starting point would be to build sustainability expertise into one's own accounting practice by practitioners reviewing their own business' sustainability.

KEY RISK MANAGEMENT ACTIONS FOR SME ACCOUNTANTS

The SME accountant can play a role to build up their clients' sustainability risk management in the following areas:

- **Map supply chain** and identify potential weak spots or areas where sustainable (or other) risks may stem from. The accountant can also function as a liaison between the SME client and its partners within the supply chain.
- **Assess sustainability impact and risks,** setting KPIs, targets and monitoring processes for reducing that impact, and publishing the business' policies and actions[7]. Creating an Environmental Management System (EMS) – a framework which helps a company achieve its environmental goals through consistent control of its operations – can help. This can be based for example on ISO 14000 family of standards.
- **Help improve opportunities and efficiencies**, identifying the potential impact on cash flow that various social, economic, and environmental measures might present. This also includes ensuring that clients take advantage of potential cost reductions, minimise cost increases, and help identify those sustainability issues that are most relevant for their particular business. Also identify and assess whether any assets owned by the business carry a risk of becoming 'stranded' and if so, help them manage the situation.

[7] Many SMEs may, in fact, unwittingly already be even more sustainable than they realise. Helping such businesses realise this can enable them to better capitalise on their 'sustainability advantage'.

- **Advice on access to funding and liquidity advantages** to make the SME clients aware of any potential tax breaks, subsidies, loans, public sector funding (whether regional, national or EU-level) or grants that they may be entitled to through their sustainability enhancing measures[8].
- **Help with sustainability reporting and communication**, which would consist of developing metrics and systems needed to capture and report on those metrics.
- **Provide assurance on what is being reported** where this is required by external parties (banks, public authorities in a green public procurement context, partners in supply chains). Specifically, accountants can provide assurance on an EMS that is already in place, if professional independence considerations permit. This and the reporting step above would come as the last stage to any sustainability risk management, once monitoring processes are in place.
- **Build partnerships in the broader SME ecosystem,** establishing collaboration and contacts with local sustainability, SME and risk management experts, thus gaining access not only to credible knowledge but also to trusted professionals that the accountant can refer their SME client to when needed.

Ultimately, it all boils down to the specificities of each SME – which depends on its size, business model, sector etc. and even the countries in which it operates. For example, European countries vary greatly on the types of difficulties that SMEs face when undertaking circular economy activities, according to Eurobarometer. The most mentioned potential difficulties are a lack of clear ideas about costs and benefits or improved work processes (27%), of clear ideas about the investment required (27%) or of expertise to implement activities (26%).

Accountants can help SMEs owners overcome their doubts and fears, help identify and implement solutions that suit them best, and guide the business through the changes.

WHAT CAN GOVERNMENTS DO?

There is only so much that SMEs, their accountants and other SME ecosystem actors can do to foster sustainability in the small business sector. An enabling regulatory framework is also pivotal in fostering sustainable transition at a sufficient scale, and ensuring fair common rules and a level-playing-field.

We call on policymakers at European and national levels to facilitate and support sustainability risk management in small businesses, and to incentivise more sustainable practices among SMEs. The following policy tools and measures can be particularly effective, if properly designed:

- offer regulatory incentives to establish environmental management systems
- give grants, low-interest loans and tax incentives for businesses willing to go beyond compliance and invest in greener technologies
- introduce sector-specific certifications and eco-labels as well as other environmental recognition awards
- set up a free-to-use online software through which SMEs can conduct a general self-assessment for a sustainability performance rating, bringing together corporate social responsibility (CSR), environmental protection, workplace safety and energy efficiency, and enabling to estimate their emissions, pollution and environmental footprint

8 According to a 2016 Eurobarometer, 70% of SMEs that undertook circular economy activities self-financed them, whilst an increasing number of financing tools and incentives are put in place to assist funding such measures: https://ec.europa.eu/COMMFrontOffice/publicopinion/index.cfm/Survey/getSurveyDetail/instruments/FLASH/yearFrom/1974/yearTo/2016/surveyKy/2110