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RISK MANAGEMENT PRACTICES IN SMALL AND MEDIUM ENTERPRISES: EVIDENCE FROM SRI LANKA

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ABSTRACT

Over the years, risk management has been identified as a vital process in the business institutions. It is further believed that risk management is less developed within the small business sector where strong enterprise culture mitigates against managing risk in a professional structured way. This study focuses to investigate the risk management practices small and medium enterprises in Sri Lanka. The study was carried out by means of questionnaire survey by collecting data from 200 firms. The study uses descriptive statistics of mean and standard deviation and correlation analysis and ANOVA in the data analysis. The results show that the management of risk is strongly concentrated on owner managers and business planning system and link between the planning and risk management are not well developed in small and medium enterprises. The attitudes of the owner managers and their knowledge towards risks play an essential role in how systematically risks are handled. Therefore, this study stresses the need of improving current planning system within the SMEs together with enhancing the owner managers' knowledge and awareness regarding risks management through proper training and development.

KEYWORDS: Business Planning, Owner Manager, Risk Management, Small and Medium Enterprises.

1. INTRODUCTION

All human endeavors involve uncertainty and risk. It is widely agreed that risk is more so in the business sector with compared to other sectors. Every business decisions and entrepreneurial act is connected with risk. This applies to business of small and medium scale as they also face several and often the same risks as bigger firms. In a real business environment with market perfections they need to manage those risks in order to secure their business continuity and add additional value by avoiding or reducing transactional costs (Dickinson, 2001).

In broad perspective, Mitroft and Alpaslan (2003) categorize emergencies and crises into three categories, natural disasters, malicious activities and systematic failures of human systems. Nature does many things to us disrupting our best laid plans and undoing much of

what human have constructed. Malicious acts are intimation on the part of fellow humans who are either excessively competitor or who suffer from character flaws. The third category is probably the most common source of crises; unexpected consequences arising from over competitive system. As a result, over the past decades, corporate risk management have been developed well beyond insurance and the hedging of financial exposures to include a variety of other kinds of risk and notably operational risk, reputation risks and most recently strategic risk.

Risk management concern, many studies have been focused on larger firms and a lower priority has been given to examine the risk management in the Small and Medium Enterprises (SMEs) where the risks are considered to be less catastrophic and most studies have concentrated solely on the risks associated with safety and occupational health and hazards.

SMEs in Sri Lanka play a significant role in economic growth and development by creating new employment, regional development, entrepreneurs and social development. However, no comprehensive investigation has yet been focused in examining risk management of SMEs in the country. Therefore, this empirical investigation aims to fill the gap by examining the current state of risk management in Sri Lankan SMEs. In particular the objectives of this study are to address the business issues and to identify

- **Which areas of risk are most important to SMEs**
- **How risk management is currently approach by SMEs**
- **Attitudes to risk, the business culture with SMEs respect to risks**

This paper is organized as follows. The second section reviews the literature relates to risk and risk management in SMEs. The third section presents a brief introduction of methodology used in the study. The forth section is devoted for discuss the results of empirical findings. The conclusion along with managerial implications is presented with the final section.

2. REVIEW OF LITERATURE

Risk can be broadly defined as any issue that can impact the objectives of a business entity and the potentiality that both expected and unexpected events may have an adverse impact on the capital and earnings. Similarly, risk characterized situations where the actual outcomes for a particular event or activity are likely to deviate from the estimate or forecast value. Risk also can traces in two directions; the outcome may be better or worse than originally expected. Traditionally, risks have been identified with two categories, static risk and dynamic risks. Static risks are the ones that cause only damages without the opportunity of earning from their occurrence. They are always negative and have the characteristics of being unexpected because they are determined by accidental events. These risks fall perfectly under the insurance policy. Dynamic risks are those that can cause either damages or earning opportunities. These are the typical entrepreneurial risks

and consequences (Mowbray and Blanchard, 1979). Alternatively, risks occur within the firms and their business environment can be divided as internal and external risk. Operational risks, financial risks and organizational and management risk are internal risks as they have their sources within the firm (Henschel, 2008). External risks occur in the business environment of the firm and can be economical, technological, political, legal or cultural changes (Scheve, 2006). Henschel (2008) states that the most relevant risk categories for SMEs are internal and strategic and business process risk.

2.1. RISK MANAGEMENT

The roots of risk management can be found in the insurance sector in the 1960s. The acquisition of insurance makes it possible to secure business against systematic risks. Currently risk management has been extended to handle of systematic as well as unsystematic risk in the business world. Risk management is a continuous monitored integrated formal process for defining objectives, identifying sources of uncertainty, analyzing uncertainties and formulating managerial resources to produce an acceptable balance between risk and opportunities (Halman and Weiden, 1997). Similarly, risk management can be defined as an ongoing process that can help improve operations, priorities and resources, ensure regulatory compliance, achieve performance targets, improve financial stability and ultimately prevent loss and damage to the entity (Dickinsons, 2001).

It is generally agreed that risk management process includes four interrelated steps including identification of risk, quantification and evaluation of risk, management and control of risks and continued reporting on the development of risks (Vaughan and Vaughan, 2001). Similarly, Smallman (1996) argues that a holistic risk management is characterized by three main aspects including continuous monitoring of all sources of risk, combination of qualitative and quantitative techniques, risk assessment and monitoring and organizational learning for a positive approach to dealing with risk, risk assessment, risk analysis and risk handling (Halman and Weiden, 1997). On the other hand, risk strategy is based on the purpose of the risk management that should include necessary advance preparation with respect to defined approach, tasks and tools. The risk assessment step is to identify, qualify, quantify and prioritize the risk while the risk analysis step deals with the consequences, options and decision making. Finally, the risk handling phase identifies what actions need to be taken on identified risks, where the actions should be either to reduce, accept, and avoid or to transfer risks.

2.2. SMES AND RISK MANAGEMENT

SMEs show little separation between the entrepreneur's strategic thinking and decision making and firm formal planning system (Lyles et al. 1993). McKierna and Morris (1994) noted that SMEs are characterized with the central role of the owners and multiplicity of duties and close identity with employees. According to Smith (1998), enterprises in their startup phase often underestimate risks or even ignore them completely. Startup SMEs usually face a high degree of uncertainties and the necessity to make quick decisions (Frese

et al. 2000). Empirical studies show that the attitudes of SMEs towards risks and their risk assessment differ significant from that of large firms.

Henchel (2008) states that risk management is a challenge for SMEs in contrast to larger firm they often lack of the necessary resources, with regard to human capital, data base and specificity of knowledge to perform a standard and structured risk management. Similarly, Matthews and Scott (1995) stated that most of SMEs do not have the necessary resources to employ specialists at every position in the firm. They focus on their core business and have generalists for the administration function. In contrast to larger firms, in SME one of the owners is often part of the management team. His intuition and experience are important for managing the firm (Dickinson, 2001). Therefore, owner manager in SME is often more responsible for many different tasks and important decisions. In fact Sparrow (1999) find that risk management practices in SMEs relate to the beliefs and attitudes of founding entrepreneurs. SMEs do not tend to use special techniques to optimize significant risks.

Literature related to risk management in SMEs is quite limited and still in an early phase of development and little studies have been focused to risk and risk management within the sector. Janney and Dess (2006) noted that SMEs are away from adopting a positive approach towards risk management due to limitations such as inadequate infrastructure, limited managerial and technical expertise, lack of financial and intellectual resources to generate substantial technological developments and change, weak information networks to locate and recognize information and knowledge that is especially relevant to them, and low investment in research and development. Similarly, a study of Turpin (2002) states that most of SMEs have no official risk strategy which is due to problems of communication with of delegating risk management competencies to employees. His study further notes that increasing competition, low of competencies to competitors, changing customer demands, wrong strategies due to lack of market data and personal absences rate are frequently and most importantly risk for European SMEs.

Matthews and Scott (1995) find that many SMEs have no explicit picture of business risk and their risk management is often not well structured nor systematic or standardized. Henschel (2008) states that lacking of expertise and knowledge in SMEs can make a huge business risk for SMEs. According to O'Hara et al (2005), SMEs identify two barriers to risk assessment; time pressure and access to suitable guidance. He noted that given assess in appropriate guidance and help SMEs can improve risk assessment efficiently. Sparrow (1999) stated that the belief and attitudes of founding entrepreneurs are more influence on risk management practices in SMEs. As a result that makes decisions in terms of their business as an entity rather than in terms of manager specific risks. Smith stated that the enterprises in their start up phase often underestimate risks or even ignore these completely. Start up SMEs usually force high degree of uncertainty and the necessity to make quick decisions (Islam et al. 2008). Empirical studies further show that the attitudes of SMEs toward risks and their risk assessment differs significantly from that of large enterprises since risk considerations in SMEs take place in a more holistic way.

3. RESEARCH METHODOLOGY

Since the study is an empirical in nature of investigation, it was carried out by collecting the data from 200 SMEs in Sri Lanka. Sample firms have been contacted by using industrial catalog maintained in Industrial Development Board of Sri Lanka. A self completion questionnaire was prepared and administered in order to collect the data. Since the fact that the owner is having main responsibility for risk management in SME, the data were collected by directing questionnaires to the owner managers of the selected firms. The questionnaire was formed basically based on the literature and it consists of four sections. First section is focused to identify the characteristics of the firms such as firm's type, nature of ownership, number of employees employed, ect. Second section is devoted to identify the risks faced by the firms with four categories, hazard risks, financial risk, operational risk and strategic risk. The last section is focused to collect the data for evaluating the nature of risk management in the firm by giving special attention to risk identification, risk evaluation, risk handling and risk monitoring and control. The study uses mean and standard deviation as well as correlation analysis and ANOVA in the data analysis. All analysis was done with SPSS 16.

4. RESULTS & DISCUSSION

The sample of the study was made up with 80 firms from manufacturing sector, 60 firms from service sector and 60 firms from retail sector. The vast majority (80%) of business represented is sole proprietorship and remainders are partnerships (13%) and limited companies (7%). The mean operating time period of the firms is 6.8 years with the standard deviation of 2.3 years. The average number of employees employed by the firms is 15 employees. Average business experience of the respondents in the field is 6.3 years with the standard deviation of 1.4 years (see Table 1).

TABLE 1 DESCRIPTIVE STATISTICS AND RESULTS OF ANOVA

Variable	Descriptive		ANOVA on industry type		ANOVA on nature of ownership	
	Mean	SD	F value	Sig.	F value	Sig.
Business age (years)	6.8	2.3				
No of employees	15.0	3.6				
Experience (years)	6.3	1.4				
Business planning**	2.1	1.1	2.31	0.58	3.11	0.32
Hazard Risks**	1.9	0.8	1.32	0.66	2.01	0.52
Financial Risks**	3.4	1.2	2.31	0.33	6.21*	0.04
Operational risk**	3.6	1.4	2.89	0.21	3.11	0.26
Strategic risks**	3.9	1.1	8.03*	0.01	5.45*	0.02
Risk identification**	2.1	0.8	2.01	0.54	3.14	0.07
Risk evaluation**	2.3	0.9	3.11	0.23	2.87	0.25
Risk handling*	2.6	1.1	2.58	0.32	1.68	0.13

Risk monitoring and control**	2.4	1.0	1.98	0.44	2.34	0.18

*** ANOVA is significant at 0.05 level**

**** measured on 1-5 scale**

It is generally accepted that business plan is basic for a risk management in terms of proper identification of risk drivers and design appropriate tools to handle them. The survey data (Table 1) show that only few have established a comprehensive business planning system. Business planning is in most SMEs do not well developed (mean = 2.1). The results further show that business planning in selected SMEs is often carryout in rather rudimentary form. The results of ANOVA also show that there is no significant difference either between industry type ($F = 2.31$, $p = 0.58$) and ownership type ($F = 3.11$, $p = 0.32$) on business planning. However, correlation results (see Table 2) indicate that firms tend to make proper business planning when they get aged in the business ($r = 0.18$, $p = 0.02$).

Quality of risk management is usually depended on the priory gives to it by assigning that task to a specific section or a person. Survey results show that supervision and review of the risk management in SMEs are extensively dominated by owner managers. These results confirm that risk management in SMEs is orientated towards the owner managers. In addition to that the extent and the quality of risk management in SMEs is further widely depended on how much time the owner managers invest in the development and implementation of an official risk strategy and how it is communicate to the respective employees. However, results show that no enough time have been invested by the owners for developing and implementation risk strategy within their firms in the previous years. They explained that they use informal approaches to manage risk associated with their business activities with help of their knowledge and past experiences they have acquired from previous circumstances. Some of respondents noted that the relationship and networking capacity they have with different parties including business peers, investors, and consultants are more important to identify and manage the risks they face in their business world.

Concerning the risk categories, strategic risks, operational risks and financial risks are dominated within the SMEs (see Table 1). The selected firms show that strategic risks which come from competitors, customers and external environment is significantly higher for them compared to the operational and financial risks since they operate in the industry which characterizes with huge competition. Operational risks come from human resources, production methods, information technology and other internal process have a significant impact on the business activities. Financial risks characterize with interest risk, exchange risk, movements and value of investment have not widely impact to SMEs when compared with the above. The ANOVA results in Table 1 show that strategic risk faced by the firms is significantly deviated on the industry type ($F = 8.03$, $p = 0.01$). Especially post-hoc of the ANOVA implies that there is significant difference between the firms in service sector and firms in retails sector on strategic risks. ANOVA further implies that financial risks and strategic risks experienced by the selected firms are significantly deviated on their nature

of ownership whether it is sole-proprietorship, partnership and limited company (F = 6.21, p =0.04) (F= 5.45, p =0.02).

TABLE 2 RESULTS OF CORRELATION

	A	B	C	D	E	F	G	H
A. Business age	1.00							
B. No of employees	0.45*	1.00						
C. Experience	0.36*	0.45	1.00					
D. Business planning	0.18*	0.11	0.21	1.00				
E. Risk identification	0.12*	0.13*	0.32*	0.06*	1.00			
F. Risk evaluation	0.08*	0.21	0.21*	0.12*	0.08*	1.00		
G. Risk handling	0.25*	0.33*	0.11*	0.09*	0.11	0.80	1.00	
H. Risk monitoring and control	0.31	0.24	0.21*	0.11*	0.16*	0.03*	0.12	1.00

*** Correlation is significant at 0.05 level**

Risk management is a continuous process by which firms undertake to identify and evaluate possible risks steams for a firm and handle and mange them for ensuring smooth function of firm. The survey results of present study show that all functions of risk management in the selected firms are in very weak position. In fact, risk identification, evaluation, handling and monitoring and control all have recorded values well below the average (average = 3) on the 1 to 5 scale. These results confirm that the risk management in SMEs is not well developed and till in the early phase of the development. Results of ANOVA results in Table 1imply that risk management functions of the selected firms are not deviated either on industry type and nature of the ownership. However, the respondents explained that they use informal and unorganized procedures in identification and handling the risks they faces in their business activities.

The correlation results in Table 2 clearly show that the firms tend to have more formal risk management process when they are getting large and aged. It further shows that the experience of owner managers has a significant positive impact of the each functions of risk management. Thus, this result confirms that the owner managers' experience and knowledge play significant role in risk management in SMEs. The business planning concerns, it is positively correlated with risk identification (r = 0.06), risk evaluation (r = 0.12) , risk handling (r = 0.09) and risk monitoring and control (r = 0.11).

These results confirm that proper business planning is required and a prerequisite for the sound risk management in the SMEs

It is widely believed that the attitudes of entrepreneurs significantly influence on risk management practices in SMEs. Concerning the attitudes of the owner managers towards the risk, the vast majority of respondents (84%) do not believe that adequate insurance for major risks preclude the necessity of regularly raising the issues of risks. Furthermore, the majority claimed that their adaptability to market changes is more important for them to minimize some of influences negatively impact to their businesses. Therefore, it is clear from the results that the adaptability to the market changes is vital for SMEs to mitigate some of market risks. While the vast majority of respondents (76%) further agreed that their business encourage taking entrepreneurial risks, very few of respondents (8%) claimed that business culture is averse to entrepreneurial risks. The respondents further explained that they tend to discuss with their subordinates and get their views before making vital decisions regarding the business activities.

CONCLUSION

This study attempts to identify the risk management practices in Sri Lankan SMEs. The results show that the SMEs attribute with less developed risk management system and less formal business planning process. However, SMEs are more likely to have a culture of encouraging entrepreneurial risk taking. Business planning of SMEs needs substantial improvement. It is stressed that a comprehensive business planning system is the prerequisite for a sound risk management. The experience of owner and their network capabilities are played significant role in risk management in SMEs. The attitudes of the owner managers and their knowledge towards risks play an essential role in how systematically risks are handled. Therefore, this study stresses the need of improving current planning system within the SMEs together with enhancing the owner managers' knowledge and awareness regarding risks management through proper training and development. The findings further stress that the need of establishing proper network between business firms and the other helping and assisting organizations to improve owner manager's experience and access to information sources.

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