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## **RISK MANAGEMENT FOR SMALL/MEDIUM ENTERPRISES**

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### **INTRODUCTION**

Risk management for small/medium enterprises is a critical subject for an entrepreneur, who is desirous to succeed in his/her entrepreneurship strides. But before we delve into it proper, let us have a definitional treatment of the topic.

Small/Medium Enterprises (SMEs) have been identified as a major player in any nation's economic growth and the main stay of the private sector and particularly industrialization. In developed countries where SMEs have been given their rightful place, their contributions are outstanding. In United States of America (USA), the states and federal governments and big corporations are respectively responsible only for about 6% and 8% of total employment while SMEs sector provide 84% of the employment. Thus SMEs generates 50% of that nation's GDP. In UK, of the 3.7 million businesses, 99% of them are described as SMEs. In the European Union (EU), one million SMEs are set up annually. SMEs accounted for 99.8% of all companies and 65% of business turnover in EU (Ariyo 2000).

Small/Medium Enterprises (SMEs) have been defined differently at various times by different countries. In Nigeria, Central Bank of Nigeria (CBN) defined it as business with an annual turnover of less than half a million naira (Oshagbemi, 1983:3). Bankers Committee defined small and medium enterprise as any enterprise with a maximum asset base of N1.5b (excluding land and working capital) and with no lower and upper limit of staff (CBN, 2006:3). Globally, SMEs are firms with fewer than 250 employees and with a turnover of less than 50million Euro or a balance sheet total of less than 43million Euro (EC Recommendation, 2003). The Committee for Economic Development (CED) of the United States of America has defined a small business as one having any two of the following characteristics a) Managers are also owners b) Owners supplied capital c) Area of operation mainly local d) Small in size within the industry (Broom H.N and Longenecker J.G in Oshagbemi, 1983:3) e) Small capital layout f) Few number of workforce g)



Volume and value of operations relatively small. Given the above definitions, we are guided by the characteristics dimension especially in view of the major target readership of this text.

Small and Medium Enterprises are usually the brain child of entrepreneurs, who are persons that have business or managerial abilities to identify and evaluate profitable business opportunities, mobilize necessary resources and initiate appropriate action plans very consistent as to ensure the realization of enterprise objective(s) (Okereke and Saale 2008:1). The entrepreneur, who may be a *traditionalist* or *pragmatist (charismatic)*, is therefore a generalist, profit-oriented, an economic leader, a promoter and above all a risk bearer. As a risk bearer or taker, his knowledge and exposure to the rudiments of risk management for his class of business enterprise cannot be overemphasized.

Risk, according to Okereke (2008:138) is the uncertainty that exists as to the occurrence of some events happening or the possibility that the actual return (from business operations) will deviate from that which is expected. It is the probability that outcomes vary from our expectations (Sanusi, 2007:21). It is exposure to financial loss arising from the operations of the business enterprise. Once an idea to enter into a business venture is nursed, risk of various nature and kind is created. Risk is generally measured by assigning probability values and employing statistical measures of dispersion such as variance, covariance, range, standard deviation, etc. This measurement and other qualitative efforts constitute risk management. Risk management does not in any way focus on avoiding or eliminating risk but geared at reducing it in consonance with the philosophy and objective (s) of the enterprise. It is a process that actively supports the achievement of enterprise implied and/or expressed objective (s). Thus, Okereke (1995:313-5) describe risk management as the process of reducing the threat of loss due to uncontrollable events. It involves the application of general management concepts, principles and techniques to risk with a view of reducing possible financial loss associated with a business undertaking. It requires drawing up of plans, directing and organizing of materials and men for the undertaking, maintenance of activity among people for the objectives involved, co-ordinating all the activities involved and controlling them to ensure that results conform with set objective(s).

#### **Risk Management: Objectives and Approaches**

The objective of risk management is essentially to reduce the adverse effect of economic risks at the least cost consistent with the goals or objectives of

the business enterprise. Risk management as a process involves a number of steps. Williams and Heins (1976) in Okereke (1995) identified five steps as follows

1. Establishment of procedures and communication throughout the organization to allow for a complete inventory and discovery of the potential (economic) risks that may arise in the activity of the business firm
2. Proper measurement of the losses associated with these risks
3. Consideration of the various alternative solutions or tools of risk management and the choice of the best tool or combination of tools
4. Establishment of the means for effective implementation of the decisions made
5. Monitoring and evaluation of the decisions reached

From the third step above, we see that there are many approaches to risk management. They include avoidance of risk; minimization of risks through good management techniques, e.g safety programme, security patrol in a business premises, say, for 24 hours; absorption of losses, ie retaining risk internally; shifting of risk to another party usually insurance companies. That is, the purchase of insurance to pay for losses.

The choice of any of these approaches should depend on its cost-benefit analysis, the objective of the business as well as the nature and type of risk involved. For the entrepreneur, who is a risk manager, he must be interested in the entire risk management processes in general and possible types of risk surrounding his business enterprise in particular.

#### **Risk Management Process in Small/Medium Business Enterprise**

This constitutes the centre of risk management. The process is comprehensive; articulating and outlining the steps required for a good risk management system. Flangen and Norman (1993) in Okereke and IHEMEJE (2006:106-15) identified the following processes a) Risk Identification b) Risk Classification c) Risk Analysis d) Risk Attitude e) Risk Response. This step by step process has been embraced by experts including William and Heins (1976). The beauty of the process is that it is applicable to every level of business undertaking micro, small, medium and big businesses and cuts across industry and sectors of the economy. Let us look at these steps on their own merit.

##### a) Risk Identification:

This involves classifying and identifying types of risk expected from an operation (s). Thus classification precedes types. Generally, risk identification originates from conscious identification of the source (s) of risk exposure before or after they have occurred or the source of financial losses arising therefrom. According to Okereke (1995) in Baridam (1995:315-9) risk can be classified into three categories as follows:

1. Pure and Speculative Risks. Mowbray et al (1969) pioneered this classification. Pure risks are threat of loss or injury without the possibility of gain. For instance, the fact that there is no fire disaster in a business firm does not in a way contribute to the profit of the business. Thus, the business owner's position remains unchanged. Unlike speculative risks, pure risks are always distasteful. Speculative risks are risks where there is the possibility of losing money in order to make profit. They are more amenable to the insurance law of large numbers.
2. Static and Dynamic Risks. This classification is dedicated to Willet (1951). He described static risks as risks connected with losses caused by the irregular action of forces of nature or the mistakes and misdeeds of human beings. Dynamic risks, on the other hand, are risks associated with changes, especially changes in human wants, improvement in technology and business firm. Static risks affect the entire society, while dynamic risks do not. Static risks are almost pure risk, whereas dynamic risks include pure and speculative risks
3. Fundamental and Particular Risks. Kulp and Hall (1958) classified risks into this form. Fundamental risks are group risks, impersonal in origin and effect, and at least for the individual, unpreventable, whereas particular risks are personal in origin and effect and can easily be controlled. From these classifications, various risk types emerge.

### **Types of Risks**

There are different types of risk facing business and non-business operators. Each type of risk falls within either of the categories highlighted above and the type of risk (s) associated with a business-small, medium or large, is a direct function of its nature, scope of operations as well as management. Okereke (1993, 1997: 88-90) identified a number of risks as follows:

**Business Risk:** This refers to the inherent variability or uncertainty of a business earnings before interest and taxes which arise from general economic depression. Thus, business risk is a function of several factors including the business firm's degree of operating leverage, the variability of sales, etc. The higher the variability of sales resulting from economic depression, the higher the business risk.

**Financial Risk:** This refers to the variability of a firm's returns to shareholders. It is the risk resulting from leverage (business level of debt financing). Thus, financial leverage is one of the several factors that affect financial risk. The use of increasing amounts of financial leverage raises the business firm's fixed financial costs. This, in turn, increases the level of earnings before interest and taxes (EBIT) that the firm must earn in order to meet financial obligations and remain in business. The use of financial leverage increases the variability of a firm's earnings per share (returns) to common shareholders. The higher the business firm's financial leverage (percentage of a firm's assets financed by debt), the greater the probability of insolvency or bankruptcy, and the greater the firm's risk which is, however, compensated in the form of higher rates of return.

**Market Risk:** This is the portion of the variability of an investment return that is caused by factors affecting the market as a whole - market conditions/movements. Such conditions or factors include:

- (i) changes in purchasing power
- (ii) changes in interest rates
- (iii) changes in investor's expectations in the overall performance of the economy
- (iv) Market reaction to unanticipated events, e.g the death of a President or a surprise sign of war, as was in the case of the 'Abiola Run' in 1994 in Nigeria.

**Liquidity Risk:** This results from poor synchronization (either unanticipated or due to inefficient management) of a business firm's cash flows.

**Purchasing Power Risk:** This type of risk arises from unanticipated increase in the rate of inflation. It is the erosion of capital by inflation. Operationally, the real values of assets, especially financial assets, are seriously affected during the period of inflation, unlike non-financial (tangible) assets. Purchasing power risk affects mostly businesses in fixed income financial assets.

**Foreign Exchange Risk:** This is the variability of changes (fluctuations) in exchange rate. It is financial loss arising from changes in exchange rate. Essentially, changes in exchange rate are inevitable in a world of more than one hundred national currencies. Business investors may advance their economic welfare by acquiring the assets dominated in currencies they expect to appreciate, and selling assets and insuring liabilities denominated in currencies they expect to depreciate. As business investors revise their holdings of assets denominated in different currencies, exchange rate should change. It is this change that forms the risk.

**Default Risk:** This risk is as a result of a borrower's inability to service his debt and/or pay the principal amount as at when due. It is also called Currency Risk.

**Political Risk:** This is the variability in investment return arising from political forces, e.g selective tax laws, discriminatory sanctions, such as compensation claims, indigenization programme, etc.

**Natural Risk:** This is the variability in a firm's earnings arising from natural disasters, e.g. flood, weather etc.

**Management Risk:** This refers to the variability of a firm's earnings arising from management. This type of risk could arise from judgmental errors, inefficiency or fraud on the part of management.

**Industry Risk:** This arises from unanticipated variations in profit performance caused by particular factors affecting one industry, e.g commodity prices.

Winninger (2000; 3-4) identified the following:

**Strategic Competitive Risk:** This is the risk arising from changes in technology, (e.g e- Commerce) which will make companies to be caught off guard and unable to anticipate new forms of competition or to respond to them in an appropriate way.

**Operational Risk:** This is the increased exposure to technological failure. There is the possibility that the computers and network technology that support the e-commerce, for example, could malfunction.

**Security Risk:** This is the risk arising from vandalization of company's installations by hoodlums.

Winger and Frasca (1991:115) also identified:

**Economic Performance Risk:** This is the variability of return caused by changes in real output of the economy. Assets returns are influenced by the

overall performance of the national economy. A sluggish economy over a long period of time inevitably leads to poor investment returns.

Other types of risk include risk of unplanned obsolescence, Confidence risk, Union risk, Maturity risk, Country risk, Price level risk, etc. In fact, different types of risk inherent in the business world are inexhaustible. They emanate from any activity that leads to financial loss.

b) Risk Classification: Risk classification helps in the analysis and choice of the best 'treatment' tool(s). Flanagan and Norman (1993:51-55) pioneered three classifications as:

- i. Identifying the consequence: this looks at the frequency, severity and predictability of the risk.
- ii. Type: This classification is based on whether a risk is pure or speculative; static or dynamic, and fundamental or particular.
- iii. Impact: This classifies risks based on who bears the effect. It may be the company, the individual or the market.

We can illustrate the 3 various types and impact of risk, as in Table 1.

Table 1: Types and Impact of Risk

EVENT	TYPES OF RISK	IMPACT
Management (Entrepreneur's) inability to take the right investment decision	Static risk, Speculative Risk	Company risk
Failure of the Entrepreneur's to identify a technical defect in, say, a lease arrangement	Static risk	Company risk
Strike action by company workers	Pure risk	Company risk
National strike action by company workers	Pure risk, Static risk	Industry/Market risk
Injury caused by an accident in or out of the bank premises	Particular risk Pure risk	Individual risk
Increase in exchange rate	Dynamic risk Speculative	Industry/Market risk
Reduction in revenue caused by the bank's inability to change to new technology	Dynamic risk	Company risk

Source: The Author's Design



- c) **Risk Analysis:** This is one of the major components in the risk management process. The main purpose of this component is to x-ray all possible options and analyzes the various outcomes of any decision. This will assist the company (entrepreneur) to take the right risk at the least cost with optimum return.

Risk analysis involves a number of steps. Flange and Norman, (1993:59) identified the following steps:

- Step 1: Consider all the various options
- Step 2: Consider the risk attitude of the decision-maker (is he a risk averter, lover, or neutral?).
- Step 3: Consider what risk that has been identified which are controllable and  
What is the likely impact?
- Step 4: Measure the risks using both quantitative and qualitative techniques.  
  
This will help to assess the impact of the risk
- Step 5: Interpret the result of the analysis and develop a strategy to deal with the risk.
- Step 6: Decide which risk to retain and one to allocate to other parties.  
Of all these steps, the fourth step, risk measurement, is most critical and not only qualitative but also highly quantitative and therefore requires further treatment.

- d) **Risk Measurement:** This is the process of determining the frequency or likelihood of a loss from an exposure and the possible severity associated with such loss (risk). Companies measure in order to:

- 1) Determine their level and possible effect
- 2) Obtain relevant information leading to choice of the best risk management tool (s) or combination of them
- 3) Generate information that categorizes the risk class of their assets portfolio
- 4) Generate information that will determine whether or not, the company is meeting set standard.

The above points explain the fact that once a company is able to obtain a good measure of their risk exposure, the choice of a management tool or strategy becomes easy.

Essentially, risks are associated with variability. It becomes normal for risks to be measured by such techniques (tools) as range, expected value, variance, semi-variance and standard deviation. The application of any of these tools depends on type of risk involved. For instance, foreign exchange risk is best measured by variance analysis, portfolio risk by standard deviation, etc. Ratios are also good risk measurement tool. In Nigeria, analysts and Central Bank of Nigeria (CBN) use ratios in measuring the risk exposure of companies and banks. For instance, short term solvency or liquidity ratios such as current asset ratio, acid test ratio liquid asset-deposit ratio, etc can facilitate the dictation of liquidity risk inherent in a business enterprise. Again, credit risk associated with a facility can be ascertained using loan-asset ratio, loan-capital ratio, loan-deposit ratio, etc.

- e) *Risk Response:* This involves choosing the most desirable risk management tool for dealing with any risk identified, classified and analyzed in the course of company's operations. As enumerated earlier, an entrepreneur can respond to risk by avoidance approach, minimization or reduction approach, absorption or retention approach or transfer approach. The choice of any of these approaches depends on the outcome of the identification, classification and the analysis done by him/her.
- f) *Risk Retention:* This is an approach used for managing risk that may prove uneconomical to be transferred. Such risk produces individually small and repetitive losses over a period of time. Retention or absorption of risk requires that the company must adopt a self-insurance approach. For instance, in the banking industry, the risk of public confidence can be treated by increasing capital base of the bank. Also agency risk can be managed through increased capital resources of the bank. The risk of non-performing loan can be managed by improving on investment advisory efforts and bad debt recovery strategies of the bank. Generally, to enhance profitability and liquidity level of companies, internal and cost control measures must be in place. Operational risk or the risk of computer failure can be retained by establishing a back-up computer system supported by infrastructure at the contingency sites rather than the primary site. Foreign exchange risk can be absorbed through hedging. It therefore follows that risk absorption or retention requires that resources be managed by putting in place corrective and controls measures

consistent with the needs of circumstance. Standard business practices must be vigorously and consciously pursued.

g) *Risk Reduction*: This is one of the risk management tools that involve minimization of risks through good management techniques. Essentially, business enterprises can reduce its risk, among others, by:

- Understanding workforce and office environment
- Constantly motivating the workforce
- Diversification of investment opportunities
- Evaluating investment opportunities
- Merger and acquisition
- Adopting result-oriented strategies
- Avoiding businesses they do not understand, as it is difficult to appreciate the inherent risk(s)
- Installing security devices like fire alarm system, circuit camera, burglary alarm system and other safety programmes.

h) *Risk Transfer*: This involves shifting the company's risks to another party, who is assumed to be an expert in the management and control of risk [s]. Insurance is one of the commonest sources of risk transfer in the Nigeria. Here, business enterprise purchase insurance to pay for the possible losses incurred in the course of their business operation. Basically, not all risk is transferable. Business enterprises respond to risks associated with their workforce, real assets, burglary, etc. by transferring them to an insurance company such as Niger Insurance Co. PLC, Cornerstone Insurance Co. PLC, etc. This is not mandatory transfer unlike the mandatory transfer that requires the company, as a matter of statutory requirement, to transfer risk to an insurance company. Example, banks are required by law to insure their deposit liabilities against possible failure with Nigerian Deposit Insurance Corporation (NDIC)

i) *Risk Avoidance*: This involves shying away from taking risk. It is total refusal to go into certain business venture. For instance, a company may adopt a policy of not venturing into a certain investment/business opportunity inspite of the returns. Also a bank can refuse to enter into a loan [syndication] or any other agreement and if it must be involved in such contract agreement, it can use exemption clause to avoid certain risks inherent on such agreement.

Succinctly, risk avoidance involves actions taken to reduce chances of unexpected financial losses by eliminating risks that are unwanted in the attainment of the enterprise objective(s).

## CONCLUSION

Let us conclude with the following risks management tips.

- \*- Always ensure that risks are matched with returns. This implies avoidance of mismatch
- \* Diversify the use of risk management techniques. Two or more techniques can be used in one risk exposure with maximum result.
  - Don't use a technique mainly because it worked for another company
  - You must consider your immediate environment and circumstance, among others
  - Use your intuition in your risk management efforts
  - Ensure that the right technique is applied to the right risk. This is to avoid tool mismatch in your risk management efforts.
  - Check the risk exposure on a continuous basis, as the market is prone to fluctuations

Flanagan and Norman (1993:24) in Okereke and IHEMEJE (2006) list some rules for risk taking by banks as follows:

- Don't risk a lot for a little
- Always plan ahead
- Always analyze both the source and the consequence of risk
- Device alternative action as a contingency measure
- Don't use other people as an excuse for inaction
- Don't take risks purely for reasons principle
- Don't take risks to avoid losing face
- Never risk more than you can afford to lose
- Be prepared to seek advice from experts
- Consider the odds and what your experience and intuition tells you.
- Consider the controllable and uncontrollable parts of the risk.

It must be stated here that *Risk Management* is not a complete elimination of risk but a deliberate and conscious effort of an enterprise to eliminate risks that are superfluous to their goals and aspirations.



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