# RISK MANAGEMENT IN CORPORATE GOVERNANCE OF SMES: FINDING INNOVATION IN TRADITIONAL THEORIES

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## 1. Introduction

Since 2008, the financial crisis has invested in the real economy: initially in the United States, then in other industrialised economies, and finally in the rest of the world.

The slowdown in growth has become a recession. This global crisis revealed significant new problems in risk assessment and management, caused by the increasing uncertainty and its effects. There emerged the need for an effective implementation of Risk Management (OECD, 2015).

This crisis demonstrates that no industry or jurisdiction is immune to inadequate or inappropriate risk management. All companies should be able to develop a policy with a full appreciation of risk and a suitable set of operating procedures to adapt to the changes of the surrounding environment in a timely manner.

SMEs represent the most important reality in the entire economic system. They are crucial in promoting economic growth at the international level and their vitality helps reduce the level of unemployment. Therefore stability and prosperity of SMEs assume systemic value for all countries (World Trade Organisation, 2013).

As in Italy, in the UK and in other countries, there is no regulatory or institutional code of risk management: SMEs do not usually adopt a formalised risk management process.

The reasons behind this immature approach, on the one hand, can derive from the lack of familiarity, the fear of change and additional costs that the implementation of a risk management system can have, while on the other hand, from the actual lack of awareness of the benefits that an integrated risk management system might have in terms of prevention and opportunities. Only a comprehensive and coordinated approach and an effective process among all functional areas can substantially improve the sustainability and profitability of SMEs by becoming a proactive prevention tool. But there

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emerges the need to develop a sound corporate governance (Soltani and Maupetit, 2013).

Consequently how could researchers lead SMEs to rethink the internal control system and risk management? What are the theoretical bases academics should refer to in order to support a sound and effective corporate governance and internal control system?

Thanks to our brief literature review, we discuss the need for companies to reassess their governance structure to ensure adequate risk management. Our research tries to answer these questions by analysing and studying in depth the most important national and international studies of academics and researchers.

We have made an attempt to develop an agenda for a discussion of the future role of risk management in SMEs. Our first aim is to underline that if SMEs aims at implementing a proper risk management function, the right corporate culture and values, they should think about the company as a complex system, coordinated in all its functions. Therefore academics should spread the original theories that generated business administration as an independent field of research in order to pursue SMEs to rethink their risk approach, by reinforcing awareness and dissemination of the risk culture in this segment.

The paper is organised as follows. The research rationale and its contributions are stated in the second section. The methodology and research questions are presented in the third paragraph, while the literature review is in the fourth section. The discussion on RQs is presented in the fifth section. The final paragraph instead deals with the conclusion and perspectives.

## 2. Research rationale and description of the specific contribution of the study

Risk is inherent to and part of the existence of every company (Bertini, 1969; Ferrero, 1987).

In particular, SMEs are more exposed to the negative aspects of risks. However, due to their flexibility, with the right tools they can tap into opportunities to increase their market share, grow and manage risks more effectively.

It is well known that SMEs constitute the vast majority of enterprises around the world and serve as the mainstay of trade and economic growth. Small and medium enterprises, in terms of family firms, represent the backbone of the economic system both in Italy and in the UK, where there are approximately three million family businesses (Zurich, 2012).

They are the key drivers of innovation, social integration and employment (OECD). Given the importance of SMEs in economic growth and development, attention to the issue of risk management becomes essential.

SMEs have little guidance on how best to manage risk and where to turn to for advice. Over the past few years few Guidelines have been published. Some of them represent Corporate Governance Codes for Unlisted Companies (OECD, 2006; ecoDa, 2010; OECD, 2015; NedCommunity, 2015). Thanks to these Guidelines, SMEs might develop an appropriate governance framework, trying to avoid negative implications for their long-term effectiveness and success. Copying the widely-recognised principles of best practice for listed companies is also not a viable solution, as the corporate governance challenges of listed companies are different from those of unlisted companies.

In fact most unlisted enterprises are owned and controlled by single individuals or coalitions of company insiders (e.g. a family). In many cases, owners continue to play a significant direct role in management.

Good governance in this context is not a question of protecting the interests of absentee shareholders (*agency theory:* Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983). Rather, it is concerned with establishing a framework of company processes and attitudes that add value to the business and help ensure its long-term continuity and success, by satisfying the stakeholders' needs (*stakeholder theory:* Freeman, 1984).

This is the reason why the International Organisation for Standardisation (ISO) in 2009 elaborated ISO 31000: 2009 about Risk Management and, more recently, in January 2016 ISO published a practical guide for SMEs about how to implement risk management in alignment with ISO 31000.

The standard, in Clause 1 states:

"*Although this International Standard provides generic guidelines, it is not intended to promote uniformity of risk management across organizations. The design and implementation of risk management plans and frameworks will need to take into account the varying needs of a specific organization, its particular objectives, context, structure, operations, processes, functions, projects, products, services, or assets and specific practices employed*".

This paper is motivated by the boards' failure, in terms of risk blindness, to manage risk prior to and during the financial crisis. Moreover we underline the need for SMEs to develop a new risk culture that might help them face uncertainties and deal with any type of risks.

We have made an attempt to develop an agenda for discussing the future role of risk management in SMEs. Therefore nowadays if academics and researchers want to find innovation in theories, they should refer to the traditional theories that consider the company as a whole dynamic system, which functions are all interrelated.

As a consequence, the paper is *international* because we investigate the most important and relevant studies of national and international academics and researchers.

It considers risk management in corporate governance of SMEs as *multidisciplinary* and aims at showing how corporate and risk governance ought to be considered and developed in these companies.

## 3. Methodology and research questions

Our research is a *critical literature review* (Saunders et al., 2009) with the objective to identify the most important international and national works that determined the bases for the risk management and internal control system area and thereafter, to classify them in order to identify gaps, issues and opportunities for further studies and research.

Our work consists precisely of a critical analysis of the principal literature contributions, both international and national, in the corporate governance field and, more specifically, in the internal control system and risk management area.

A literature review seems to be a valid approach, as it is a necessary step in structuring a research project and it forms a fundamental part of any research (Easterby-Smith et al. 2002) that helps identify the conceptual content of the specific field (Meredith, 1993) and guides towards theory development.

Our research is based on previous theoretical considerations and follows a clear process that brings to conclusions and perspectives for both academics and practitioners.

The process of analysis follows four steps (Srivastava, 2007):

- *Definition of the unit of analysis*: the unit of analysis has been defined as a single research paper/book. We further delimited the material (research paper/book) to be collected as per our scope;
- *Classification context*: we concentrated on the *problem context* related to risk management;
- *Material evaluation*: the material is analysed and sorted according to the classification context. This allows identification of relevant issues and interpretation of the results. The research aim is pursued through a *deductive approach*;
- *Collecting publications and delimiting the field*: we focused both on primary sources, such as reports, conference proceedings and

documents published by organisations, and secondary sources such as books, edited volumes and journal articles.

To establish a time span, a starting point was set at 1900, as our review starts with the analysis of corporate risks. Afterwards we concentrated on the original theories in the business administration field and on their evolution.

Library databases were used by researching works with the following keywords: risk management, SMEs, risk governance, risk.

As references were accumulated, we selected them and we drove our discussions and conclusions in order to answer the following research questions:

- *RQ1*: In this context of profound change in the risk approach, how could researchers lead SMEs to rethink risk management?
- *RQ2*: What are the theoretical bases academics should refer to in order to support a sound and effective corporate governance and internal control system?

## 4. Literature Review

We begin our review by analysing some of the most important works about the concept of risk.

One of the first definitions of risk is attributed to Bernoulli, who in 1738 proposed to measure risk with the geometric mean and to minimize risk by spreading it across a set of independent events (Bernoulli, 1954).

The topic of risk has been the subject of careful and important studies in the general economic field since the beginning of the twentieth century. For example Willet (1901), Fisher (1919), Knight (1921), Hardy (1931) and the Italian Chessa (1929) were the most relevant.

In the business administration field, the research of Chapman and Cooper (1983), Oberparleiter (1955), Corsani (1941), Sassi (1940) and Gobbi (1919) was particularly important. The common element of all these studies is that risk can be seen as the possibility of economic or financial losses or gains, as a consequence of the uncertainty associated with pursuing the course of an action. But more specifically risk is linked to an *adverse eventuality*.

Risk is intrinsic to doing business (Zappa, 1956; Ferrero, 1987) and it has consequences in terms of economic performance and professional reputation, but there are also environmental, safety and social considerations. These risks may be internal or external, direct or indirect. Despite the underlying element of uncertainty, it is often possible to predict risks and to set in place systems and design actions to minimize their negative consequences and maximize the positive ones (Kaplan and Mikes, 2012; Giannessi, 1960). Those risks that arise from disorder can be controlled through better management and governance. This way, businesses that adopt a risk management strategy and a proper planning and programming are more likely to survive and grow (Amaduzzi, 1961; Capaldo, 1965; Brusa, 2012).

More recently, Kaplan and Mikes (2012) underlined that the first step in creating an effective risk management system is to understand the qualitative distinctions among the types of risks that organizations face. In their opinion there exist three categories of risk: preventable, strategy and external risks.

These researchers analysed several companies in different sectors and tried to elaborate models and possible solutions to manage all types of risks. There emerged the need for managers to communicate properly and to build an organisational structure that best adapted to their company.

Therefore the concept of risk is not unique but depends on the situation in which the company operates, on the uncertainty every company might face and on the consequences that certain events can have on the business (Chessa, 1929; Bertini, 1987).

Spencer and Siegelman (1964) state that risk can be considered as *the quantitative measurement of an outcome, such as a loss or a gain, in a manner such that the probability of the outcome can be predicted*.

Uncertainty and negative consequences were also discussed by Ferrero (1968). He wrote in his masterpiece *Istituzioni di economia d'azienda* that there are two kinds of uncertainties: objective and subjective. The former are linked to the unknown in an absolute sense and they depend on the knowledge and the environment that surround the company. Subjective uncertainties instead can be dominated by the management because they are linked to insufficient information and to the informative system of the company.

As stated by Oberparleiter and Bertini, corporate risks can be individuated, but sometimes they cannot be measured.

Bertini (1987) wrote that the study of risk consists of the interpretation of hypotheses and values that a company can assume when putting into effects plans.

There emerges the need to define a proper and effective risk management process.

Risk management theories evolved in particular after the COSO Report (1992) and its updated version (2004), elaborated by Committee of Sponsoring Organizations of the Treadway Commission. Several researchers concentrated on the definition of the risk management (RM) process and on the Enterprise Risk Management (ERM), by analysing all phases and activities (Brustbauer, 2016; Di Serio et.al., 2011; Henschel, 2009; Cantino, 2007).

The movement towards enterprise risk management (ERM) (COSO, 2004) has shifted the focus to a more holistic appreciation of risk. It highlights that appropriate risk-based controls need to be put in place to help ensure, as far as possible, that organizational objectives are achieved (Soin and Collier, 2013).

Consequently, the risk management process can be seen in a strategic way, because it is functional to the development of the company strategy and control (D'Onza, 2008; Coso Report, 2004). That aspect was first underlined by some researchers of Harvard University (Ansoff, 1965; Hofer and Schendel, 1978).

The risk management process deals with planning, organising, directing and controlling resources to achieve given objectives when unexpectedly good or bad events can happen (Head, 2009). Risk management is not just an important concern to individual organizations, it also provides a link between organizations and the environment in which they operate. Financial and environmental disasters affect multiple organizations and whole sections of society (Soin and Collier, 2013).

Giuseppe D'Onza (2008) underlines that risk management, as part of the internal control system of each company, is the key driver for value creation, competitiveness and profitability. Therefore risks should be assessed and managed properly through a process that involves all company functions and that can be divided into four phases: risk assessment, risk evaluation, risk management and reporting.

National and international studies highlight the immaturity with which companies and, in particular, SMEs face risks. The reasons for this immature approach can derive on the one hand from the lack of familiarity, the fear of change and additional costs that the implementation of a risk management system could result and, on the other, from the actual lack of awareness of the benefits that an integrated risk management system might have, not only in terms of prevention, but also as regards the opportunities (Marcelino-Sádaba et.al., 2014; Hiebl, 2013; Thun et.al., 2011).

Vargas-Hernandez (2011) underlined that a further motivation to support the implementation of risk management in SMEs is to protect innovative projects, which are fundamental to gain competitive advantage and succeed in the market, but necessarily involve risky decisions and activities.

Many studies instead focused on the role of risk management in SMEs and on the risk attitude of those companies (Gao et.al., 2013; Mutezo, 2013; Ellegaard, 2008; Gilmore et. al., 2004; Hollman, 1984).

Some other researchers concentrated on specific kinds of risk in SMEs and how they are managed (Poba-Nzaou, 2011; Sukumar et. al., 2011; Vickery, 2008).

We must underline that there is a different and critical approach towards risk management, which is represented by the research of Power.

The work of Michael Power (2004, 2007) raises a number of issues that are of particular interest for management accounting and control researchers as well as the roles of management accountants. There are two aspects that are particularly relevant: the side effects of risk management and the relationship between risk management and uncertainty: Power (2004, 2007) highlights the 'risks of risk management' and the emergence of 'secondary' or 'defensive' risk management.

He suggests that: "experts who are being made increasingly accountable for what they do are now becoming more preoccupied with managing their own risks" (Power, 2004, p.14).

Power argues that this "culture of defensiveness" (p. 14) can be seen in the 'individualization' of risk by various professionals – whereby, experts are becoming pre-occupied with managing their own risk which necessitates reflexive behaviour (Beck, 1992; Giddens, 1990). Further side effects include blame avoidance (Hood, 2002), fear of sanctions, legalization and the re-drawing of (organizational) boundaries that arguably may lead to a re-enforcing of the 'box ticking' culture.

In terms of risk management and uncertainty there have been substantial developments in organizational practice that focus on risk management and issues of governance, but the impact of risk and uncertainty has not been fully explored. Managers have always faced uncertainty, which is a central feature of any organizational setting. Power (2007) argues that when uncertainty is organised, it becomes a risk to be managed. The range of uncertainties deemed in need of management has significantly increased and includes threats such as operational risks, reputational risks and strategic risks. These changes have implications for management accountants in relation to the identification, monitoring, control and mitigation of risk and yet, the discourse of risk and the way it is managed is not always a feature of the wider management control framework in organizations.

As Power (2004) has argued, "secondary risks to an organization's reputation are becoming as significant as the primary risks for which experts have knowledge and training" (p.14).

There has been a growing attention and a trend towards world-wide government regulation utilising risk-based regulatory approaches that focus on tighter internal control mechanisms.

In fact risk has also been cited in several laws, such as Legislative Decree 231/2001 in Italy or Bribery Act in the UK.

Moreover the risk approach is the basis in the statutory audit, where it was first introduced in the International Standards on Audit (ISA) and it was studied by several researchers (Bava, 2011; Marchi, 2004). In particular, Holm and Birkholm Laursen (2007) analysed thoroughly the changes of the role of the external auditor in corporate and risk governance, giving interesting perspectives.

Therefore our research fits into this framework.

This preliminary research and critical review of the literature on risk and risk management aims at laying the groundwork for further empirical studies.

We seek to close the gap in the literature review, as stated by Falkner and Hiebl (2015) and Verbano and Venturini (2013), by suggesting at first a theoretical basis and leading SMEs to understand the importance to implement and control the risk management process.

The ambitious aim is to try to convince SMEs to consider the opportunity to develop and implement an effective internal control system and a risk approach.

Moreover, with our research we try to underline that companies should pay attention to the role of risk culture within their business as creating corporate values, communicating them and training the employees should be some of the key drivers for the sustainability of each company.

## 5. Discussion

Thanks to our critical review of the literature, we can notice that the concept of risk and its theorisations date back to early Nineties: these theories are not new.

In order to answer the first research question, we found that previous research underlines that risk is intrinsic to doing business because every company faces uncertainties that are strictly linked to corporate risks.

Over the past forty years, the business administration field of research has been deeply influenced by the American studies of management.

Researchers all over the world started concentrating on specific functions and areas. This attitude led to important developments in research.

As Zappa suggested to his students a long time ago, researchers should continue to build the *skyscraper* of business administration, step by step.

Our critical review of the literature aims at being the link between the past, with its traditional theories, and the future.

Riccardo Varaldo (2015; 2014) wrote that in order to play the new game of innovation, companies and researchers should use knowledge as one of the inputs for the innovative processes that Italy can benefit from. The lack of strategic vision is one of the worst diseases for Italian companies.

As Bertini (1969) stated: *analysing the risk management process means to observing from a different point of view the business administration of each company, considered as a whole and a unique system.*

That is the basis of our work and the common answer to *RQ1* and *RQ2*.

We tried to grasp the meaning of this concept; if we want to find a managerial solution for SMEs to implement a proper risk management process, in our opinion, academics should help managers/owners to clearly understand what a company and its functions are.

And there emerges the significance of our title: *finding innovation in traditional theories*.

The only way to try to solve the crisis and to find an innovative tool is to start from the corporate governance and the internal control system (Brunetti, 2015; Coda, 2015; Sorci, 2014; Brunetti and Coda, 1994). We should focus on people, their culture and values (Caselli, 2012; Catturi, 1996).

Vittorio Coda (1967) underlines how the following paradigm,

*governance* ➝ *strategy* ➝ *business management* ➝ *objectives/results*

that derives from the studies of Zappa (1927), Onida (1951; 1954) and Masini (1955; 1961; 1970), can be considered by young researchers.

First of all everything starts from a sound and effective corporate governance and internal control system. Strategy and strategic planning can be set up only having in mind the final objectives and results that the company aims at obtaining. Anyway, in order to achieve the defined objectives and results, there emerges the need to have good business management.

Recently, Tiziano Onesti, Nunzio Angiola, Silvio Bianchi Martini, Stefano Garzella and Anna Lucia Muserra (2012) studied certain important stages of business life that present *extraordinary* management profiles and that usually involve a significant change of the governance arrangements, performance and value attributable to company assets.

Consequently, we should go back and consider the company as an economic and unique entity (Amaduzzi, 1953; Ferrero, 1987; Bertini, 1990; Brusa et. al., 2013). This is the only way for governance boards to have a complete overview of the business.

In the case of SMEs, owners and managers might concentrate on the several relationships and influences that can be found in a company. They should find the *equilibrium* (Marchi, 2014; Ferrero, 1987; Brusa et. al., 2013).

And as we mentioned above, the analysis of risks, carried out in a systematic and formalised way, can help every SME find problems in specific areas and solve them with specific actions.

The risk management process, in a strategic perspective, can monitor every single risk in every single function or process (Bromiley et. al., 2015). It is a transverse, dynamic and effective process, which helps develop appropriate communication and training among the employees (Coso, 2004; Sole 24Ore, 2016).

After having in mind these theoretical bases, the practical implications are much easier to understand.

As underlined by the Global Management Accounting Principles, elaborated by the Chartered Institute of Management Accountants (CIMA) and the American Institute of CPAs (AICPA), the best approach to deal with business risks has its fundamental element in an effective communication and training. The risk culture and framework should be communicated to and understood by all employees and business partnerships. Risk information is used to support the organisation's rapid response capability to prevent an incident escalating into a crisis.

Employees should have a high awareness of reputational risk and its implications for the organisation's activities and information flows.

We tried to take the cue of the study of Holm and Birkholm Laursen (2007), who suggested researchers to analyse the interactions between internal control and risk management. But we tried to do more, by connecting this process with the entire functioning of a company.

As Giovanni Ferrero stated in *Impresa e Management* (1987), the principles of management do not have a normative content, but they can contribute to build a theory of business administration. In order to be valid, such theory should suggest appropriate ways of thinking that might help set up concrete problems.

And our ambition is to suggest an appropriate way of thinking, starting from the combination of both past and present theories, with the final aim to find a solution that might lead SMEs to implement an effective risk management process.

## 6. Conclusion and perspectives

Our critical review of the literature can be considered as an attempt to develop an agenda for further research on the role of risk management in SMEs.

By analysing theories and perspectives of the most important national and international researchers with a deductive approach, we tried to draw some considerations about how SMEs should rethink their internal control system and risk management. We investigated what theoretical bases academics should refer to in order to support the development of a sound and effective corporate governance and internal control system.

Therefore, thanks to our brief literature review, we underline that the solution to implement a proper risk management function and improve the right corporate culture and values in each company is to go back to *tradition*.

Traditional theories bring innovation because we should concentrate on the company as a complex and dynamic system, with a process overview. Therefore we need to start from the old theories on business administration, those that can be considered as dogmatic because they do not need further demonstration and which generated business administration as an independent field of research.

As Zappa suggested to his students a long time ago, researchers should continue to build the *skyscraper* of business administration, step by step.

Afterwards, Bertini (1969) stated: *analysing the risk management process means observing from a different point of view the business administration of each company, considered as a whole and a unique system.*

Professor Coda underlined that the only way to try to solve the crisis and to find an innovative tool is to start from the corporate governance and the internal control system (Coda, 2015). Therefore we should focus on people, their culture and values (Caselli, 2012).

These are the main points and the core of our research.

The *risk blindness* of several SMEs can be solved only thanks to a correct risk culture that has to be communicated and spread throughout the company.

Our study would be the basis to build a theory which aim is to suggest appropriate ways of thinking that might help set up concrete problems. In particular, starting from the combination of both past and present theoretical bases, the final aim is to find a solution that might lead SMEs to implement an effective risk management process. Therefore, concentrating on risk management would be a way to *find innovation in traditional theories*, a way to start rethinking the concept of *company* and its functioning.

Without these theoretical bases, it would be difficult to follow the suggestion of Philip Bromiley, Michael McShane, Anil Nair and Elzotbek Rustambekov (2015), who argue that "to contribute to the ongoing risk management discussion, management scholars need to take a more prescriptive stance and pay more attention to the effectiveness of different practices and activities".

As mentioned above, in 2014 the Chartered Institute of Management Accountants (CIMA) and the American Institute of CPAs (AICPA) elaborated four Accounting Principles that suggest an approach to deal with business risks. In particular the fundamental element is an effective communication and training. The risk culture and framework should be communicated to and understood by all employees and business partnerships.

A risk framework has to be consistent with the organisation's strategy, business model, ethical values. Risk management is embedded in the management accounting function and is integrated with the performance management system.

The board of directors can be supported in its risk governance responsibilities through the provision of high-quality information on the organisation's principal risks and risk management system. This is together with other relevant information on the external environment and key warning signs, such as excessive complexity or a weak challenge culture.

Every company should provide confidence to its stakeholders that risks are being managed properly through insightful reporting on risks and uncertainties (the 'what') and its risk management and control systems (the 'how').

Therefore our literature review might have several implications for both professionals and academics.

With our study we aim at suggesting that in order to run a company, it is fundamental to have theoretical bases in the field of business administration and risk management. Professionals, directors, CEO and managers might manage their company processes, fraud and bribery risks in a different way and put into practice some guidelines deriving from practical reports as best as possible.

Our contribution to the literature is related to the ambition to underline an appropriate way of thinking, starting from the combination of both past and present theories, with the final aim to find a solution that might lead SMEs to implement an effective risk management process.

As regards the limits of our research, first of all, this study represents the first step of a far deeper analysis. As mentioned above, our work is a preliminary critical review of the literature on risk and on the problem of implementing a risk management process in SMEs.

Therefore our concluding remarks should be empirically studied and tested by a group of companies. Consequently one of the possible future developments could be some qualitative research based on a multiple-case study or we could try to test if there is a managerial solution for SMEs to implement the RM process, maybe by starting from a general obligation of compliance.

Perspectives for further research in the interrelationships between risk and control issues of corporate governance of SMEs are abundant.

As being part of the group of researchers in the business administration field, we should consider the perspectives also for companies and in particular for the small and medium ones. In a stakeholders' view of corporate governance, we should not forget that every company should pay attention to stakeholders' needs. Stakeholders demand quality, reliability and transparency. This is the reason why researchers should help SMEs understand the importance and the role of an effective internal control system and risk management process.

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