**New Perspectives in Managing Risks in SMEs**



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# NEW PERSPECTIVES IN MANAGING RISKS IN SMES.


## Abstract

The present study concentrates on risk management in SMEs and provides the hypotheses and reasons behind the non-implementation of this process.

This research represents a theoretical contribution in the field of corporate and risk governance of SMEs. It differs from other studies because it does not follow incremental gap-spotting ideals but instead emphasizes assumption-challenging in the construction of research questions, which are formulated by problematizing some dominant assumptions in existing research. To do that, this paper follows the philosophical and epistemological concepts of abduction and pragmatism, elaborated by Charles Peirce.

The purpose of this paper is to understand from which point of view it is necessary to restart analysing the topic of risk management in SMEs and to suggest a new perspective that could lead managers and owners of small and medium enterprises to improve their risk attitude.

In particular, the research underlines the necessity to concentrate on the human being and his personality and to consider risk management as an integral part of decision-making.



***Keywords:*** **risk management, SMEs, theoretical paper, decision-making, new perspectives**


## Introduction

Since 2008, the global crisis has revealed significant new problems in risk assessment and management, caused by the increasing uncertainty derived from a demanding environment. Risk management is a transversal process to each company and has a strategic importance because it helps managers set and possibly achieve the objectives of their companies. So why is there a lack of sensitivity in adopting a sound risk approach, especially in SMEs?

Why, despite all the literature regarding the importance of having an adequate internal control system, are there still cases of bankruptcy and scandals?

One of the most important reasons lies in the fact that the management of risks in some realities, especially in those very small, is seen as a burden and a final objective itself.

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

In many countries, there is no regulatory or institutional code of risk management: SMEs do not usually adopt a formalised risk management process. But in some cases there is no need to formalise this process or to implement the ERM systems.

This research represents a theoretical contribution in the field of corporate and risk governance of SMEs. It differs from other studies because it does not follow incremental gap-spotting ideals but instead emphasizes assumption-challenging in the construction of research questions, which are formulated by problematizing some dominant assumptions in existing research (Davis, 1971). To do that, this paper follows the philosophical and epistemological concepts of abduction and pragmatism, elaborated by the American philosopher Peirce.

This paper has been motivated by the need to understand from which point of view it is necessary to restart analysing the topic of risk management in SMEs and to suggest a new perspective that could lead managers and owners of small and medium enterprises to improve their risk attitude. In particular, there will be the necessity to concentrate on the human being and his personality and to consider risk management as an integral part of decision-making.

The paper is organised as follows. The research design with details about the methodology and epistemological approach are stated in the second section. The theoretical background about the risk management process in SMEs is presented in the third paragraph. New perspectives on the theme and discussions about theory development instead are in the fourth section. The final paragraph instead deals with the conclusion.

## Research Design

This research represents a theoretical contribution in the field of risk management in SMEs. It differs from other studies because it contradicts incremental gap-spotting ideals, by emphasizing assumption-challenging in the construction of research questions (Alvesson and Kärreman, 2007, 2011; Sandberg and Tsoukas, 2011).

There are several works following different methodologies concentrating on the management of risks in SMEs. They focus on specific kinds of risks or on procedures to be implemented in a small- and medium-sized company. They all underline the importance of developing a sound risk governance and an appropriate approach.

But why are still there corporate failures? Why is still there an immature approach in managing risks in SMEs? Why is risk management still regarded as a burden or a major cost?

It seems that academics should investigate more the real reasons behind this phenomenon.

This study follows a methodology that is less focused on gap-spotting and incremental contributions. The aim is to formulate research questions by problematizing some dominant assumptions in existing research (Davis, 1971). Formulating novel research questions through problematization involves not just using a particular preferred meta-theoretical standpoint in order to challenge the assumptions of others (as is often the case in the paradigm debates) or as in various applications of critical perspectives (Alvesson and Sandberg, 2011). 'Real' problematization also involves questioning the assumptions underlying one's own meta-theoretical position (Alvesson and Sandberg, 2013a). The ambition is to unpack one's own position sufficiently so that some of the ordinary held assumptions can be scrutinized and reconsidered in the process of constructing novel research questions.

The aim of the problematization methodology 'is to come up with novel research questions through a dialectical interrogation of one's own familiar position, other stances, and the domain of literature targeted for assumption challenging' (Alvesson and Sandberg, 2011, p. 252). This approach would support a more reflective-scholarly attitude (Abbott, 2004) and consider a different epistemological approach.

To do that, the following methodological principles are central (Alvesson and Sandberg, 2013b):

(1) identify a domain of literature;
(2) identify and articulate assumptions underlying this domain;
(3) evaluate them;
(4) develop an alternative assumption ground;
(5) consider it in relation to its audience;
(6) evaluate the alternative assumption ground.

Successful problematization is a matter of creativity, intuition, reading inspiring texts that offer critical insights (but without being accepted as a new fixed framework), talking to other people, having specific experiences, or making observations that may trigger new thinking (Alvesson and Sandberg, 2013a). This methodology also has the advantage of facilitating focus, working as a support for a research identity around being a problematizer and a path-up setter (and not a gap-spotter), and facilitating description of what one has done and accomplished (Alvesson and Sandberg, 2013b). The conventional notion of rigour, requesting to systematically vacuum clean existing literature to demonstrate how to make a contribution to the extant literature, should be combined with imagination (Cornelissen and Floyd, 2009; Donaldson et al., 2012; Weick, 1989). However, while conventional rigour in the sense of logical consistency and thoroughness requires to analyse the underlying assumptions of the existing literature, in this paper those assumptions are studied in order to conceptualize the subject matter in question: risk management in SMEs.

To do that, this paper follows the philosophical and epistemological concepts elaborated by the American philosopher Peirce: abduction and pragmatism.

Peirce abduction had its proper place in the context of discovery, the stage of inquiry in which we try to generate theories which may then later be assessed. In his opinion abduction is the process of forming explanatory hypotheses and it is the only logical operation which introduces any new idea. Deduction and induction, then, come into play at the later stage of theory assessment: deduction helps derive testable consequences from the explanatory hypotheses that abduction has helped the researchers conceive, and induction finally helps reach a verdict on the hypotheses, where the nature of the verdict is dependent on the number of testable consequences that have been verified.

Peirce's pragmatism has a sort of a constructivist approach because he admits the possibility to change one's own opinion, values and thought, and it represents another form of relativism in which objective and convincing critiques might change the reality and the assumptions of a researcher.

Constructivism considers knowledge and learning as the result of a collective dimension of interpretation of reality. The new knowledge is built not only on the basis of what has been gained in past experiences but also through sharing and negotiation of meanings expressed by a "community of interpreters." The "construction" is therefore based on cognitive maps that serve to individuals to orient themselves and build their own interpretations.

In this case, the study aims at creating hypotheses to solve the following research problems:

- *Research problem 1*: Why, despite several studies underlying the importance to implement control activities and procedures to manage risks, SMEs do not integrate risk management in their business?
- *Research problem 2:* In this context of profound change in the risk approach, how could researchers lead SMEs to reconsider risk management?
- *Research problem 3*: What are the theoretical bases academics should refer to in order to support the development of sound and effective corporate governance and internal control system?

## Theoretical background.

*Risk and uncertainty: the importance of managing risks.*

It is necessary to present the theoretical background about the topic of risk and uncertainty in order to show the central role that risk management has been acquired over the past few decades.

Starting from the topic of risk, Bernoulli 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 concept of risk has been the subject of careful and important studies in the general economic field since the beginning of the twentieth century (Willet, 1901; Fisher, 1919; Hardy, 1931).

Knight (1921) was one of the most important thinker and distinguished between risk and uncertainty with respect to the nature of decisions made in a company. He associated generating economic profit with making entrepreneurial decisions under uncertainties. This uncertainty is complex because it cannot be reliably hedged unless it is reducible to risk. In his opinion, the mathematics of probability that is used for risk calculations may lose relevance. Fast-and-frugal heuristics, on the other hand, provide robust strategies that can perform well under uncertainty. Therefore, risk and uncertainty are strictly linked to the topic of decision-making (Mousavi and Gigerenzer, 2014).

In the business administration field, the research of Oberparleiter (1955), Chapman and Cooper (1983) and Sassi (1940) was particularly important. The common element of all these studies is that risk can be 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 considered an *adverse eventuality*.

Risk has consequences in terms of economic performance and professional reputation, in addition to environmental and social considerations. 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). Those risks that arise from disorder can be controlled through better management and governance. This way, businesses that adopt a risk management strategy and adequate planning and programming are more likely to survive and grow (Amaduzzi, 1961; Brusa, 2012).

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 of certain events. Furthermore risk is inherent to and part of the existence of every company (Bertini, 1987; Ferrero, 1987). Uncertainty and negative consequences were also discussed by Ferrero (1987). He stated 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.

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. 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 that organizational objectives are achieved (Soin and Collier, 2013).

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; Henschel, 2009). In particular, COSO Report underlines that the risk management process has eight components interrelated with the management process of the company. These components are the following: internal environment; objective setting and Risk Appetite Framework (RAF); event identification; risk assessment; risk response; control activities; information and communication; and monitoring.

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). Therefore it deals with planning, organising, directing and controlling resources to achieve given objectives when unexpectedly good or bad events can happen (Head, 2009) and it also provides a link between organizations and the external environment in which they operate. In addition, risk management is the key driver for value creation, competitiveness and profitability (D'Onza, 2008).

The research of Michael Power (2004; 2007; 2009) presents a different and critical approach towards risk management because he raises a number of issues, also concerning the role of management accountants, that are of particular interest for management accounting and control researchers. Two elements are particularly relevant: the side effects of risk management and the relationship between risk management and uncertainty. Power argues about 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).

Power states 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) underlines 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.  Therefore the new wave of risk management can be regarded as a defensive reaction to an increasingly demanding environment.

There emerge the need for an 'intelligent' risk management which is not control obsessed, but based on knowledge and on risk appetite framework, an impoverished concept that may lead to board failure and that should be redefined and enforced (2009).

*Risk management in SMEs: the state of the art.*

As regards SMEs, they have little guidance on how best to manage risk and where to turn to for advice. Over the past few years few Guidelines, representing conceptual frameworks, have been published. Some of them represent Corporate Governance Codes for Unlisted Companies (OECD, 2006; ecoDa, 2010; OECD, 2015) and in 2009 the International Organisation for Standardisation (ISO) elaborated ISO 31000:2009 about Risk Management and in 2016 ISO published a practical guide for SMEs about how to implement risk management.

The literature reveals that risk management in SMEs is still in an early phase of development and is rather fragmented (Verbano and Venturini, 2013; Marcelino-Sádaba et al., 2014). Despite that, several national and international studies highlight the immaturity with which companies and, in particular, SMEs face risks. This 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 (Hiebl, 2013; Thun et al., 2011). 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.

Good governance in this context is not a question of protecting the interests of absentee shareholders (*agency theory:* Jensen & Meckling, 1976). 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).

Furthermore many SMEs face resource constraints (Jarillo, 1989). Consequently, existing resources need to be used with care as erroneous decisions will have more serious complications than they would in large businesses (Amelingmeyer and Amelingmeyer, 2005).

Therefore risk management would better cope with these resource constraints (Smit and Watkins, 2012) and deal with the issues of survivability and growth (Islam et al., 2008).

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

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

Furthermore research on the most effective procedures of risk management in SMEs was conducted (Henschel, 2010), even if it is still at a very early stage (Rautenstrauch and Wurm, 2008). In particular, Henschel (2010) identified the missing integration of the identified risks into the business planning as the main problem. According to him, this integration is needed to determine the complex risk position of each company, which is also influence by the firm size.

In other studies, Islam et al. (2008) and Islam and Tedford (2012) aimed at identifying potential risks existing within the SME infrastructure, by developing and testing a strategic RM framework. This model consists of five steps: identification of disturbances (undesirable events and setbacks), identification and classification of root causes, classification of origins of disturbance, risk assessment and risk handling and monitoring and control. The research findings suggest that SMEs encounter disturbances in the areas of production, safety and business operation. These studies also highlighted a lack of systematic RM strategies among the SMEs surveyed.

McCarthy (2000) explored how entrepreneurs think about risk and deal with it in the strategy formation process, demonstrated that risk-taking propensity is subject to change, depending on the business development. McCarthy and Block et al. (2015) underlined that entrepreneurs should be considered in their own uniqueness because with learning, organisational context and history, they influence the development of a sound risk approach.

As regards risk assessment, Herbane (2010) underlined that this task represents a daily activity but it has a tacit and implicit nature rather than being formalised in a planned risk analysis. Risk framing is a result of the owner's personal experience and knowledge derived from being part of informal networks.

## New perspectives in managing risks in SMEs.

The theoretical background of the previous paragraphs helps answer the first research problem, because it underlines that the above-mentioned studies in the field of risk management in SMEs concentrated on specific kinds of risks, or on the strategic aspect of this process or on the importance to develop appropriate procedures and control activities in order to assess, manage and monitor risks.

The research of Power, McCarty, Block et al. and Herbane instead centre the point and the real problem: many SMEs do not integrate the risk management process in their business because there is little knowledge about the potential benefits, there is a lack of a developed risk attitude and behaviour. It is a matter of mindset, managers' personality and history of the company. That represents the answer to the first research problem and the first hypothesis, as explanation of the phenomenon.

Afterwards, to answer the second and third research problem, by trying to suggest an appropriate way of thinking to find a solution that might lead SMEs to consider risk management as fully integrated in the business, it is important to analyse what COSO Report (2004) states in the Executive Summary: *Limitations in managing risks can result from the fact that human judgment in decision making can be faulty. Decisions on how to respond to risk and establish controls need to consider the relative costs and benefits, breakdowns can occur because of human failure, such as simple errors or mistakes, controls can be circumvented by collusion of two or more people, and management has the ability to override ERM decisions. These limitations may prevent boards from achieving the entity's objectives.*

Consequently, there emerges that risk management activities are strictly related to strategic decision-making. The new perspective for the improvement of managers and owners' risk attitude and for the integration of the risk management process in the business of every SME is to start analysing the way decisions are made. Decision-making is the process of choosing the best alternative to achieve individual and organizational objectives (Guo, 2008). Therefore this process is inherent in all managerial functions and is closely related to the planning function. People responsible for setting and achieving certain objectives are also responsible for managing the related risks.

There are different models describing the decision-making process. In this case, the research refers to the model elaborated in 2008 by Kristina Guo for health care managers, called DECIDE, which is an acronym that stands for six different steps:

- D: define the problem;
- E: establish the criteria, being as specific and precise as possible in order to understand what should be achieved or avoided;
- C: consider all alternatives that could meet the criteria;
- I: identify the best alternative;
- D: develop and implement a plan of action;
- E: evaluate and monitor the solution and feedback when necessary.

The steps of this model are related and they are similar to those of the risk management process (Figure 1).

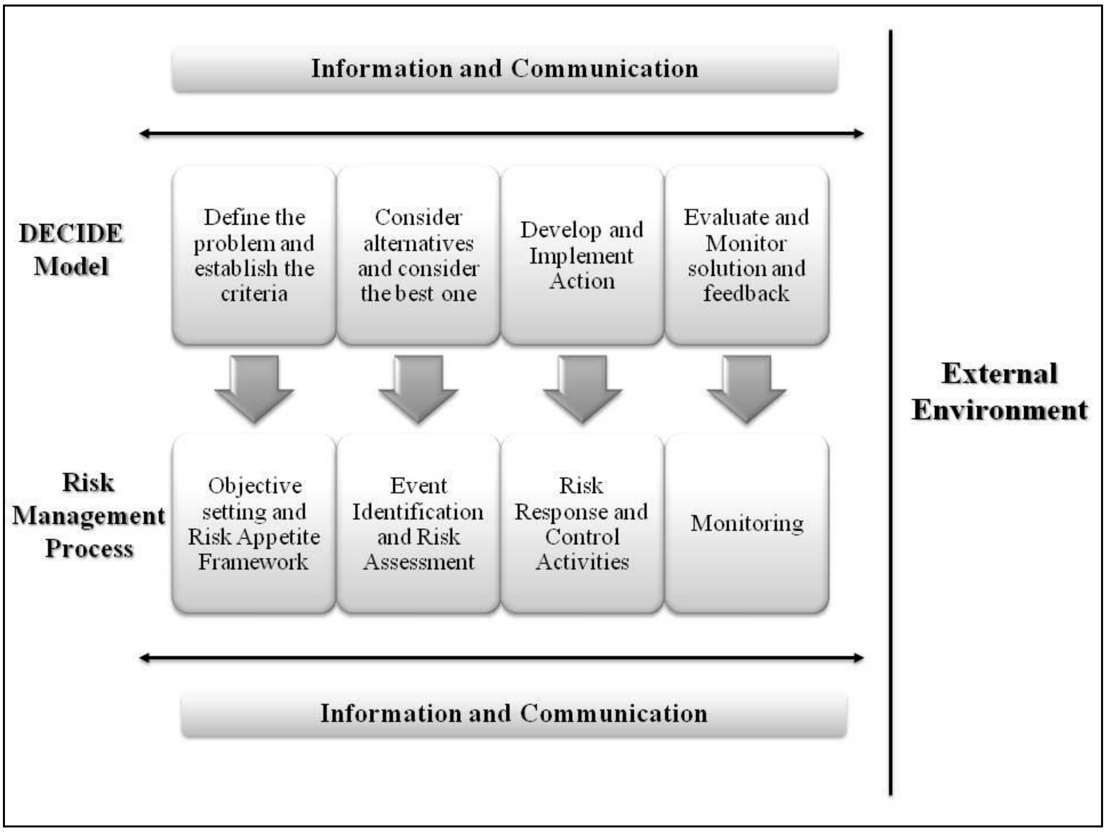


Figure 1. *Risk management process and decision-making model: a comparison.*

Defining the problem and setting the objectives are the first step in both processes. It is important to establish the risk appetite and the way decisions could be made. Afterwards, every manager should consider the possible choice to make and identify events that could generate risks. Thirdly, there emerges the need to make the choice and respond to the risk with appropriate actions. The final step of both processes consists of evaluating and monitoring the solution. It is not enough to just make a decision. It is crucial to evaluate the decision made and actions implemented and to investigate ‘what could go wrong.’ This step helps prevent, minimize and overcome all possible adverse consequences. Feedback is important because it provides information related to the decision or risk response. Feedback helps a manager find out whether the decision or control activities led to the intended results, even if unintended consequences may have occurred. Information and communication are always present during these processes.

In SMEs risk management, as entrepreneurs do not usually implement it formally, may become fully embedded when they make a decision, as they are both crucial in setting and achieving the objectives. Furthermore, improving knowledge, the risk appetite and the awareness of how decisions should be made means implicitly to start developing a risk consciousness, which can be translated into a sound risk approach. Moreover corporate culture, values and ethics play a fundamental role in each company because they represent the internal environment that can affect the business management.

## Conclusion

This research underlines and demonstrates that in the field of risk management in SMEs it is important to understand why in most of the cases risk procedures and control activities are not implemented. There is no need to further underline the importance and the role of the internal control system and of risk governance because other researchers did. The real problem is to understand from which point of view it is necessary to restart analysing again this subject matter and to suggest a new perspective that could lead managers and owners of small and medium enterprises to improve their risk attitude.

To solve this problem, the solution might be to start concentrating on the human being and on the way he makes decisions for his company. Furthermore it is fundamental to consider that a preliminary and, often unconscious, risk analysis is conducted while making the decision. Therefore by starting improving the awareness, responsibility and sensitivity to risks, managers and owners would improve their knowledge about their company and about the risk appetite framework. Only after passing this step, then we could talk about procedures and control activities to be implemented and about the formalisation of this dynamic and transversal process.

Risk management, as integral part of the organisational decision-making process, enables the small and medium-sized company to be resilient and agile in all its activities by dealing with consequences of unforeseen events.

Integrating risk management means adopting ways to enhance and improve the managerial processes that already exist. Therefore it is necessary to first understand how decisions are made and implemented and then determine how managing risks should be integrated into those decisions.

This theoretical analysis contributes to existing knowledge as it extends the platform for research on strategic decision-making in SMEs, by associating it to the risk management process in order to provide a new way of regarding it in SMEs.

One of the limits of this paper is that it is the first step of a far deeper analysis that should lead to further qualitative and empirical investigation for researchers in the field of corporate governance and risk governance of SMEs and it might be useful for managerial practice.

For owners and managers of SMEs, a better understanding of the decision-making process and the potential benefits of having a risk-oriented mindset provides the basis for improving the risk appetite framework and therefore enhancing the setting of organisational objectives.

For practitioners and professional accountants, this study could be useful in providing the evidence that they play a key role for managers and owners of SMEs, because they are consultants with the aim of being collaborative in the decision-making process and helping them achieve the objectives, satisfy the stakeholders and create value over the long period.

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