

## Chapter 54

# SME Financial Management: A Risk Management Perspective

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### ABSTRACT

*Regulators' efforts to create awareness of risk management in Small and Medium Enterprises (SMEs) have heightened since the 2008 recession which affected many economies. The objective has been to stress the fundamental role of risk assessment and mitigation in the protection of business processes and profitability of SMEs. This has been hard to achieve due to the inadequate financial and operational processes within small and medium enterprises. This chapter presents an exploration of risk management in SMEs and a simplified approach to SME risk assessment and operational risk mitigation.*

### INTRODUCTION

The business management literature has largely neglected the theme of risk management for SMEs. The aim of this chapter is to explore the current state of risk management in SMEs and to reveal the problems which small and medium sized enterprises face in financial management from an operational risk management perspective.

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, and for the purposes of the Basel Accord

it includes legal and compliance-related risks (BIS, 2001). Examples of these risks include rogue trading, fraud/forgery, settlement failures, inappropriate sales practices and poor accounting and financial controls. Operational risk has contributed to the failure of some companies with the greatest failure recorded within the small and medium enterprises.

Unlike other major types of business contingencies, operational risk is complex, difficult to control and includes a wide spectrum of causal factors. This therefore makes it imperative that a suitable 'wide' management approach be defined for its management by SMEs. This required 'wide' approach to operational risk management

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has deterred SMEs from actively mitigating their operational risks, which has led to high impact losses and significant occurrence of risk events.

Operational risk management as a relatively new discipline has no generally acceptable standard for a holistic risk management in SMEs, especially the mitigation of operational risk. This is the risk which companies incur from their day-to-day activities or operations. Unlike other types of business risk, it is very difficult to determine the vulnerabilities of operational risk events.

A mitigation approach to assess the risk management sophistication of SMEs has been discussed in the chapter. The approach discussed does not imply a 'one-size fit all', rather a guide and directive towards operational risk mitigation, while adjusting for company-specific situations. This will mainly include the consideration of pre-set organizational risk appetite and risk tolerance levels.

It is vital to say that the safety and survival of SMEs is crucial for Europe's economy, as well as the rest of the world. As SMEs need simple, flexible, efficient and cost-effective operational risk management procedures to aid financial management, it is therefore essential to produce a simplified risk management and risk assessment approach for SMEs, which will be a solution created for non-expert users and for small organisations with relatively simple framework and components.

For SMEs, the establishment of a risk management system is essential to their survival, since it affects their ability to continue to receive credit from banks. When rating a small and medium enterprise, the lending bank will also assess the proper implementation of a risk management frameworks and processes in the company. This allows the evaluation of financial capability and capital base of the company as well as their system of planning and corporate governance

Banks hesitate to avail these companies with credit facility due to poor risk management practices as stated earlier.

## **The Analogy**

Small and medium size enterprises are generally busy doing the thing they do best - plying their trade or profession. Change rarely arrives announced. Evolution, not revolution, is the natural order. It is a creeping progressive thing.

### **It's a Bit like "The Frog in the Saucepan"**

If you put a frog into very hot water it immediately leaps out in order to save its own life.

However, if you put the same frog into cold water and heat it slowly the frog will remain placid and simply boil to death.

Many businesses are not much smarter than the frog. When things change almost imperceptibly, day by day, what is the stimulus to act today when you didn't act yesterday? There's always tomorrow, the main problem for risk management in SMEs.

## **The True Concept of Risk for SMEs**

The concept of risk can be expressed as the potentiality that both expected and unexpected events may have an adverse impact on the operations of a business. The incidence of risk is more severe for small and medium size enterprises. This is because of the limited size of their operations and inability to absorb shocks and operational risk events, including capital erosion and loss of profitability.

The term "Risk" can be represented as the probability of occurrence of a financial loss or uncertainty of financial loss. This can also be measured in terms of frequency of occurrence; hence business risk can be measured on a scale, with certainty of occurrence at one end and certainty of non-occurrence at the other end. When the probability of occurrence and non-occurrence is equal, risk is at the greatest level. Risk can be broadly defined as any issue that can impact the objectives of a business entity, be it financial

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