THE PRACTICES OF ENTERPRISE RISK MANAGEMENT (ERM) IN SMALL AND MEDIUM ENTERPRISES (SMES) – A LITERATURE REVIEW

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1. INTRODUCTION

Small and Medium Enterprises (SMEs) have been the backbone of economic growth in most countries, particularly in emerging countries, and they continue to play a vital role. When compared to large corporations, SMEs had the highest proportion of job creation, highest revenue growth, and highest employment growth, according to the research of 49,370 businesses in 104 countries based on the World Bank Enterprise Surveys (ES) database (Ayyagari et al., 2011). In Malaysia, there is a wide range of SME industries that contribute to the country's GDP by representing the total number of businesses in various sectors. As a result, these industries had a considerable impact on the country's economic growth. These industries have become the most important to the country's economy because of prior contributions to SMEs; the government has taken initiatives to encourage these industries in terms of SMEs development (Stern and Loeprick, 2007). Thus, SMEs are one of the largest industries, encompassing a wide range of businesses such as trading, services, manufacturing, and agriculture. Hence, in many nations, SMEs account for 90 percent of all business establishments. Similarly, according to the Department of Statistics Malaysia (DOSM) (2020), Malaysian SMEs account for around 97.2 percent of the country's total establishments.

1.2 Problem Statement

In emerging countries, most SMEs have productivity challenges (Ayyagari et al., 2011). Low productivity is a risk factor as well as a sign of SME failure or crisis (Ropega, 2011). Small businesses are vulnerable to both external and internal threats. Externally, business is rapidly changing, resulting in a great deal of unpredictability, such as changing client preferences, new product innovation, and technical improvements. Human error, corruption, technical failure, production disruption, and other internal hazards face SMEs (Dickinson, 2001). When risks develop, they have an impact on the organization's performance in terms of cost, quality, and time, resulting in delays and obstacles in achieving the goals.

Management has been a key issue in recent years, contributing to the demise of countless SMEs. For example, SMEs in Malaysia have closed due to a lack of knowledge about marketing channels and a failure to develop marketing networks. The biggest challenge faced by SMEs in Malaysia, according to Hashim and Wafa (2002) and Muhammad (2010), is a lack of expertise about marketing tactics, branding, and client loyalty, as well as a lack of good relationships with other domestic and foreign firms (Khalique et al., 2011).

Aside from that, the Covid-19 pandemic crisis has had an impact on Malaysian SMEs. Disruption of business operations and the temporary shutdown of businesses are major problems for SMEs during the lockdown period. According to Datuk Seri M Saravanan, Minister of Human

Resources, from March to December 2020, 2713 SMEs were compelled to close their doors due to the government's abrupt execution of the MCO. This circumstance has also prompted most SMEs to face challenges because of internal management issues, which have resulted in salary reductions or unpaid salaries for their employees. As a result, Enterprise Risk Management (ERM) could be a risk management technique for SMEs.

2. LITERATURE REVIEW

It is critical to put in place an effective ERM program to reap the benefits. Companies that use ERM, according to the literature, have a better firm value. ERM adds value by ensuring that all material risks and risk-return tradeoffs are thoroughly investigated by operating management and employees across the organisation (Nocco & Stulz, 2006). ERM also promotes corporate performance by supporting decision-making (Hoyt & Liebenberg, 2011; Gordon, Leob, & Tseng, 2009).

Risk management is essential for increasing the value and effectiveness of an organisation. Furthermore, many Malaysian SMEs fail to adopt adequate risk management, resulting in project failures such as cost overruns, schedule delays, and poor quality. Because there is a scarcity of studies in this field, researchers have decided to investigate the elements that determine the success of ERM techniques. There are various ERM models in use right now. However, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is the most used model, and it is used as the basis for evaluating ERM in this study (Arene et al., 2010; Wan Daud et al., 2010). The ERM methodology is based on COSO's internal control-integrated framework, which was published in 1992 to provide a common method for managing internal control mechanisms (Bowen et al., 2006).

2.1 Definitions of SMEs

SMEs are defined differently in different nations. There is no generally accepted definition of SMEs (Altman, Sabato, & Wilson, 2008). However, various indicators are often used to define an SME including the number of employees, annual sales, stock market, fixed capital investment, the number of technical equipment such as plant and machinery, and the rate of SME growth. According to Altman, Sabato, and Wilson (2008), SMEs can be characterised based on total annual sales and the number of employees. A firm is categorised as SME if its annual sales are less than 50 million Euros or it employs less than 250 employees. Altman, Sabato, and Wilson (2008) also stated the classification of SMEs in the United States is based on four criteria: (1) profit orientation; (2) having a premise in the United States; (3) contributing to the country's economic growth through tax contributions; and (4) not exceeding the size of the numerical standard of the industry involved. However, this concept differs from the definition of SMEs in Nigeria which SMEs are enterprises with less than N100 million in sales and fewer than 300 employees (Ogechukwu, 2011).

In Malaysia, the definition of SMEs is based on annual sales value and the number of employees. Figure 1 shows the detailed definition of the SMEs category. Microbusiness in manufacturing refers to a business that generates sales turnover of less than RM 300,000 a year or number of full-time employees less than 5 while small businesses have annual sales ranging from RM300,000 to RM15 million with an employee of 5 to 75 employees. Annual sales must range between RM15 million and RM50 million for medium-sized firms, and the number of employees is between 75 and 200 employees. In services and other sectors, a business is classified as micro size when the annual sales are less than RM300,000 and the number of employees is less than 5. Small size businesses if its annual sales range between RM300,000 and RM3 million, and the number of employees is between 5 and 30 employees. Annual sales for medium-sized firms must be at least

RM3 million and no more than RM20 million. The number of staff ranges between 30 and 75 (SME Corp. Malaysia, 2013).

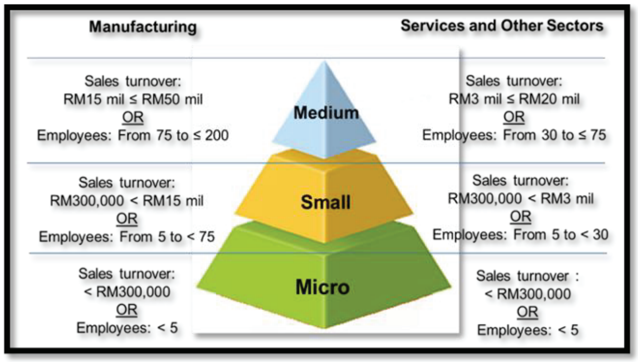

Figure 1: Detailed Definition of SME Category
(Source: SME Corporation Malaysia, 2013)

To summarise, the definition of SMEs varies and is classified based on different indicators or criteria around the world. The size of annual sales and the number of employees is two indicators of SMEs that have been widely utilized in previous studies.

2.2 Definitions of Enterprise Risk Management (ERM)

COSO (2004) defined ERM as a process that is influenced by an entity's board of directors, management, and other personnel and is used in strategy setting and across the enterprise to identify potential events that may affect the entity, manage risk to be within the entity's risk appetite, and provide reasonable assurance about the achievement of entity objectives. COSO (2004) reflected certain major ERM ideas in this definition, as follows: (1) it is a continuing process that runs through a system; (2) it is applied by employees at all levels of a company; (3) it is used in strategy positioning; (4) implemented throughout the organisation, at all levels and units, and includes taking a portfolio risk opinion at the system level; (5) designed to identify anticipated events that, if they occur, will affect the system and manage risk within its risk capability; (6) capable of providing reasonable assurance to a system's management and board of directors; and (7) geared toward achieving the objective.

According to Smit and Watkins (2012), risk management methods must be adopted by management to build a risk strategy in response to prospective risks. As a result, managers must be prepared with risk management abilities because they will oversee developing activities to mitigate any hazards. In addition, ERM improves risk response decisions by allowing managers to recognise and choose from a variety of risk mitigation options, including risk avoidance, reduction, sharing, and acceptance. ERM aids in the reduction of operational surprises and losses, allowing organisations to improve their ability to foresee and respond to forthcoming events, reducing surprises and associated costs or losses. ERM also recognising and managing numerous and cross-enterprise risks, where every organisation faces a variety of risks that affect various elements of the business, and ERM enables effective answers to the related consequences, as well as integrated responses to multiple risks. ERM aids in proactively finding and realising possibilities by assessing a wide range of possible occurrences, allowing management to better recognise and capitalise on opportunities. Better capital deployment allows management to review overall capital requirements and enhance capital allocation by receiving credible risk information.

ERM is characterised as an integrated framework for managing several sorts of risks, including credit risk, market risk, operational risk, economic risk, political risk, and social risk, to improve the value that businesses gain (Lam, 2000). Instead of responding and reacting after threats have occurred and damage has been done, ERM entails planning and preparing organisational risks before difficulties exist (Barton et al., 2002). Risk management, according to Liebenberg and Hoyt (2003), is a coordinated risk control strategy that shifts the risk management role's focus from being largely defensive to becoming increasingly aggressive and strategic.

2.3 Previous Studies of ERM

Previous studies focused on a wide range of subjects, including ERM's components and impacts. Holton (1996), for example, investigated the elements that determine ERM effectiveness and discovered that internal factors have a role. Corporate culture, procedures, and technology all play a role in risk management within firms, according to the conclusions of this study. Members or individuals on BODs must also be able to manage risks in the business culture, according to the report. Organizations, on the other hand, rely on procedures to change existing procedures to conform with ERM. Kleffner et al. (2003) conducted one of the first studies on the factors that influence ERM implementation in businesses. Over a third of respondents have implemented ERM, and a larger proportion of the remaining respondents are moving in that direction, according to the survey. The influence of the Risk Manager, Board of Directors support, and compliance with Stock Exchange standards were cited as reasons for implementing ERM, with organisational structure and overall aversion to change serving as major deterrents. According to Beasley et al., (2005), board and senior management leadership on ERM are critical for widespread adoption. Other organisational variables, like size, auditor type, industry, and country of residence, are also important in explaining the amount of ERM adoption, according to the study.

In the beginning, most ERM studies are exploratory, intending to find the financial characteristics of ERM adopters (Lam, 2000; Kleffner et al., 2003; Liebenberg & Hoyt, 2003; Pagach & Warr, 2007; Lin et al., 2012). Liebenberg and Hoyt (2003) discovered, for example, that more leveraged firms are more likely to hire CROs. As a result, firms with a greater risk profile are more likely to use ERM. Similarly, Pagach and Warr (2007) find that firms that are highly leveraged, volatile, and have a history of bad stock market performance are more likely to use ERM. Insurers with a higher reinsurance ratio and better geographical diversification are more likely to use ERM, according to Lin et al. (2012). Insurers appear to reduce reinsurance purchases and reduce asset portfolio volatility while increasing derivatives positions after implementing ERM, implying that insurers reduce reinsurance costs while increasing financial risk costs through increased derivative usage and less volatile asset portfolios.

Meanwhile, Tan and Lee (2021) highlighted that the probability of adopting/considering ERM approaches is linked to efforts such as the formation of a risk management team and the adoption of risk appetite and/or risk tolerance statements in an organization. Nevertheless, the global pandemic COVID-19 has brought new challenges and risks to businesses, meaning that ERM will continue to evolve.

2.4 Importance of ERM to SME

SMEs are regarded as inefficient in dealing with potential risks and uncertainties (Yusuf & Dansu, 2013). As a result, the competence of SME managers to appropriately identify risks and take adequate risk management procedures is important to the industry's long-term sustainability (Yakob et al., 2016). Tahir and Razali (2011) emphasised that risk must be completely integrated because it is a key emergence element for the comprehensive approach to risk management is known as ERM. This is like Monda and Giorgino (2013), who indicated that ERM includes a complete perspective of risk which assumes the relationship between one risk and another. Furthermore, Oslon and Wu (2005) highlighted that ERM is a systematic approach to managing various types of risks.

Therefore, effective risk management approaches enable organizations to accomplish their objectives while increasing the value of their stakeholders (Yazid et al., 2008). Furthermore, an effective ERM implementation enables organizations to make the most use of their resources and thus maximise their profits (Yakob et al., 2016). Indeed, the recently updated ERM framework by COSO (2017) stated that integrating ERM across entities will allow for multiple benefits including increasing opportunities, identifying, and managing risks across entities, encouraging positive outcomes and benefits, lowering negative shocks, decreasing performance variability, increasing utilization of resources, and the rising value of the firm. As a result, firms' risk exposure may be efficiently managed and reduced through the implementation of ERM and helps the firm accomplish its objectives.

3. CONCLUSION

Risk management and its impact on business success have previously been studied by academicians from all over the world. The manufacturing, information, financial services, pharmaceutical, and construction industries account for the vast majority of research (Cucchiella & Gastaldi, 2006; Jardine, 2007; Rosman, 2009; Kutsch & Hall, 2010; Wang & Huang, 2010). The majority of this research, particularly in the manufacturing industries, was undertaken in other countries, and there are few studies on risk management implementation in Malaysian SMEs. Risk management is essential for increasing the value and effectiveness of an organisation. Furthermore, many Malaysian SMEs fail to adopt adequate risk management, resulting in project failures such as cost overruns, schedule delays, and poor quality. Because there is a paucity of study in this field, researchers have decided to look at the elements that determine the success of ERM techniques.

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