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# The Role of Risk Management on Financial Performance of Small and Medium Enterprises in Kenya

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**Abstract:** ***It is necessary for every small business to manage its risks in order to minimize the loss exposure. SMEs in their operations encounter many risks such as political, natural disaster, credit and operation risks. Poor performance of SMEs is becoming a concern as many of them die immaturely. Therefore this study aimed to investigate the role of risk management on financial performance of small and medium enterprises in Kenya. The study was guided by the following objectives; to examine the role of entreprise risk management on the financial performance of SMEs; to analyse the role of strategic risk management on the financial performance of SMEs; to evaluate the effect of financail risk management on financial performance of SMEs and to establish the role of operational risk management on the financial performance of SMEs. The study is based on the protective motivation theory, risk compensation/risk homeostasis theory and situated rational theory. Empirical review shows that do not embrace risk management seriously due to lack of knowledge and skills. SMEs should focus on implementing comprehensive risk management systems in their businesses. The study adopted a desk research design. The target population was 100 SMEs that were selected for best practices as at 31st December, 2015. The study used secondary data mainly from financial statements of the Companies and other company documents like business plans and strategic plans. It was concluded that risk management practices affect the financial performance of SMEs and was recommended that SME s should adopt appropriate risk management approaches to manage risks in their organisations.***

**Keywords:** Risk management, Proactive management, Spiral inflation, Response costs, Venture capital

## 1. Background of the Study

[1] defines the term risk as the possibility for danger, negatively unexpected circumstance to occur. In most of economic publications, risk refers to the negative deviation from the plan [2]. In finance, risk is related to hazard towards an investment, or loan [3]. In terms of business organisations, risk is the possibility that an event, either expected or unexpected, may create an unfavourable effect on the organizations.

In the course of their operations, SMEs encounter many risks such as political, natural disaster, credit and operation risks especially during the start-up and growing stage. They usually confront these risks offensively to grow which is in contrast with large firms that usually take risk defensively in order to ensure operation strength. However, the ability of SMEs to withstand risks is lesser compared to that of the larger firms [4]. In addition, being synonymous with limited resources and weak structural features, SMEs are more likely to be exposed to the harmful effects of risks compared to larger enterprises [5].

It is necessary for every small business to manage its risks in order to minimize the loss exposure. [6] argue that risk management should be a major concern for SMEs particularly because they are more sensitive to business risk and competition. They opine that risk management will assist in the development of contingency plan that can help to stop the erosion of organizational income and consequently improve performance. In this regard, SMEs thus require accessible and standardized tools to help in identification of risks and match them with appropriate techniques.

The adoption of a Risk Management (RM) methodology has several potential benefits [5]. One is that it can lead firms to decrease their risk of failure. RM also ensures that there is continuity in production and trading which leads to promotion of the enterprise's external and internal image. Risk management also helps an enterprise in adequately selecting the type and the level of risk that is appropriate for the firm to take to maximize its value [6]. Finally, the ability to anticipate risks and proactive management of those risks by an enterprise is critical in creating and nurturing core business value by maximizing profits and minimizing costs.

Whilst the risk-taking behavior among corporate is encouraged, identifying the manageable level of risk is done inappropriately. Risk management emphasizes the capabilities of a business to anticipate changes, not the avoid risk. Avoidance of risks means waiting for the event to happen then react to it, rather than prepare for the changes. In reality, many organizations choose to avoid risk, as their risk management strategy. On one hand, this strategy allows fully protection from particular losses but on the other hand, deprives them of profit and might cause other risks [7].

In German, [5] found out that SMEs employ rudimentary risk management approaches with no established link between risk management and business planning. The implication is that SMEs do not embrace risk management seriously in their management approach. There is a general perception that SMEs fall short of risk management knowledge and skills. This is in agreement several studies [8]. This implies that SMEs are exposed to risk and therefore their financial performance is negatively affected

According to [9], external risks in form of regulatory requirements, lack of skills and labour unrest are the most dominant among the manufacturing SMEs in South Africa. They concluded that the SMEs have the risk management capability. In Nigeria, study of 50 SMEs in Lagos concluded that standard risk management strategy by SMEs will result in their sustainability [10]. It was recommended that entrepreneurs should consider risk management as an integral part of business management.

In Kenya, a survey of SMEs concluded that 87% of SMEs reported improved performance in their business after adopting proper management and Governance systems [10]. A study on how risk components affect strategy implementation in Kiisi Town concluded that risk identification, analysis and monitoring has a strong relationship with strategy implementation [11]. Recently, Kenya was hit by spiral inflation that exposed the inability of many SMEs to deal with external risks. As a result of the inflation, banks interest rates were increased and SMEs were unable to obtain and service their debts. Some SMEs closed due to this. It is possible that those that had good risk management strategies in place were less affect. It is on this background that this study found it necessary to investigate the effect risk management and performance of the SMEs in Kenya.

### 1.2 Statement of the Problem

Despite the necessity for a comprehensive risk management program, many SMEs rarely have detailed risk assessment and management strategies. The mechanism to prevent the harmful effects of risks is also not systematically developed and performed. A Study by [12] returned that SMEs place too little emphasis on risk management. Most small and medium enterprise owners according the study usually consider risk management as an issue relevant only to large companies. The fact that engaging in risk assessment and management requires a certain budget and human resource also hampers their ability to set up a comprehensive RM program. This is so as SMEs are characterized with scarcity of resources-both financial and human resources. SMEs therefore have little options left and as a result, they have to face most uncertainties and risks confronting them. [13] says that SMEs are unable to absorb most of these uncertainties and risks.

On the other hand, poor performance of SMEs is becoming a concern as many of them die immaturely. Several studies have been done locally on SME with regard to management and performance of SME: [14] did a study on analysis of management constraints affecting performance of SMEs in Kenya and found that lack of managerial skills and inexperience was responsible for their inability to assess business performance accurately. [15] also returned that there was a positive relationship between risk management practices and the financial performance of SACCOs, depicting the relationship between risk management practices and financial performance in organizations. Other studies [16] and [17] have focused on the impact of risk management on the financial performance of commercial banks and SACCOS.

There are limited studies that have highlighted effect of risk management with regard to the financial performance of Small, Medium Enterprises. It is on this ground that this study sought to fill this gap.

### 1.3 Objectives of The Study

The aim of this study was to investigate the role of risk management on financial performance of small and medium enterprises in Kenya.

The specific objectives were:
1) To examine the role of entreprise risk management on the financial performance of SMEs.
2) To analyse the role of strategic risk management on the financial performance of SMEs.
3) To evaluate the effect of financail risk management on financial performance of SMEs.
4) To establish the role of operational risk management on the financial performance of SMEs.

## 2. Theoretical Literature

Protection Motivation Theory (PMT) was developed by [18] as a framework for understanding the effect of fear appeals. The theory was originally created to help clarify appeals of fear. It proposes that that human beings seek protection based on four factors: perceived severity of a threatening event, perceived probability of the occurrence or vulnerability, the efficacy of the recommended preventive behavior and the perceived self efficacy. Protection motivation stems from both the threat appraisal and the coping appraisal. The threat appraisal assesses the severity of the situation and examines how serious the situation is. The coping appraisal is how one responds to the situation [19].

The coping appraisal consists of both efficacy and self-efficacy. Efficacy is termed as the individual's expectancy that carrying out recommendations can remove the threat. Self-efficacy is the belief in one's ability to execute the recommended courses of action successfully [20]. Primary prevention involves taking measures to combat the risk from occurring [21]. Secondary prevention involves taking steps to prevent a condition from becoming worse for example obtaining a court order blocking bankruptcy proceedings.

SMEs may apply this model in risk profiling. Profiling is the ranking of the risks facing the organization using the four factors considered in this theory. Risks may be grouped according to the impact if it occurs which is the perceived severity, the chances that the risk will occur which is the perceived probability of occurrence, the actions required to avert the risk which is the efficacy of recommended preventive action and the ability of the organization to take the preventive action which is the self efficacy. This approach of risk profiling enables the SMEs to anticipate risk before it occurs and take the appropriate measure to prevent it from occurring. It also guides them on areas where



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they should direct their efforts and resources in risk management.

According to [22], the threat appraisal process focuses on the source of the threat and factors that increase or decrease likelihood of maladaptive behaviours. It is also differentiated from the evaluation of stressfulness or impact of the event in that is assesses what is threatened, rather than simply the degree of stress or negativity of an event. Theoretically, higher threat appraisals should arouse management in taking up preventing and coping measures.

The coping appraisal entails the response efficacy, self-efficacy and response costs. Response efficacy is termed as the effectiveness of the recommended behavior in removing or preventing possible harm. Self-efficacy is the belief that one can successfully implement the recommended action. The response costs are the costs associated with the recommended action. The amount of coping ability that one experiences is the combination of response efficacy and self-efficacy, minus the response costs [23].

With regard to this study, the coping appraisal process focuses on the adaptive responses and SME's ability to cope with and avert the threat. The coping appraisal is the sum of the appraisals of the responses efficacy and self-efficacy, minus any physical or psychological "costs" of adopting the recommended preventive response. Coping Appraisal involves the SME's assessment of the response efficacy of the recommended behavior as well as SME's perceived self-efficacy in carrying out the recommended actions. PMT posits that threat appraisal is one determinant that impact an SME to adopt a given behavior responses. Studies by [22] suggest that as an SME's perception of risk increases, it is more likely to protect its self against risk.

According to [23] there is a level of risk which people are generally willing to take. This level of risk can be pictured as the thermostat which regulates the temperature of a house. The Risk Homeostasis Theory (RHT) transfers the homeostatic effect of a thermostat to risk behaviour. RHT states that like a thermostat has a target temperature, people have a target level of risk. People will change their behaviour in order to maintain their target level of risk.

Wilde [23] posits that the level of risk which people are willing to take depends on four different factors: the expected benefits of risky behaviour alternatives, the expected costs of risky behaviour alternatives, the expected benefits of safe behaviour alternatives and the expected costs of safe behaviour alternatives. One of the most important features of RHT is the perception of risk. For homeostasis to occur, the decision maker should perceive a level of risk belonging to a situation or a change of situation. When a situation is perceived as being risky to some extent the driver maker can decide whether the risk is acceptable or not and from that decision alter his behaviour.

[24] states that accidents can cause risk perception, an employee who was involved in or witnessed an accident might be more perceptive of the risk in the future. Again, feeling unsafe may cause the employee extra workload and strain causing an increase in the probability of accidents. [25] did a study on two groups of Norwegian adolescents of which the experimental group took part in a traffic safety campaign. The traffic safety campaign changed the risk perception of the adolescents in relation to speeding and recognition of traffic hazards. The participants reported that less speeding accidents and less risk behaviour in traffic after the traffic safety campaign [25]. The fact that other traffic safety campaigns were found to be less successful is explained by the researchers that this specific campaign focused on risk perception whereas other campaigns mainly focused on attitudes towards traffic safety [25].

This theory can be applied in explaining the behaviours of SMEs. Firms engage in business with the major motive of maximising returns. The level of returns has inverse relation with risk. It is likely that the firm which takes more risks earns more returns than that takes less risk. Therefore, some level of risk is normal for a business. The most important role in risk management is to assess the level of risk that the firm can take and release the rest by taking preventive or cope up actions. For example, opening a new branch in a war infested town may produce high returns due to limited competition but there is high cost of risk including losing the entire business to war. The other example is tax evasion is a risky behaviour that increases profits made. With regard to the expected cost of risky behaviour alternative evading tax causes legal fines that may exceed that tax evaded by the SMEs. The expected benefit of safe behaviour which in this case is tax compliance is higher chances of financial lending from Banks and other financial institutions.

Situated rationality theory posits that it is wrong to assume that safe behavior is always inherently rational and high risky behavior is inherently irrational. There are always justifications for people to take risky behaviors. People take the risky moves with the knowledge of the risk they carry but still go on for a reason. An investor who chose to buy a junk bond amidst availability of Treasury bond is an example. Treasury bonds carry very low risk while junk bonds carry very high risk. The investor will choose the risky bonds because he wants to get the high returns the junk bonds pay.

SMEs appetite for high risk may be explained by this theory. Individuals have different attitude towards risk evaluating gains and losses with respect to their own point of reference. [26]. They take on risky decision such costly borrowing, risky expansion plans into unknown business areas and field. The element of risk taking is considered a major element of entrepreneurs [27] SMEs should evaluate their risk appetite properly so that they take only the risk they can afford and avoid that that cannot afford.

The theory also hypothesizes that risks are perceived in the context of other risks and dangers which may be considered more immediate. This highlights the relativity of risk and counters the view of risk-taking as irrational. The theory conceptualise risk as the product of social interactions and negotiated actions, shifting the unit of analysis from the individual to the social relationship. [22] asserts that social relationships are embedded in wider patterns of power and dominance, so that power differences will influence the activity occurring within them.

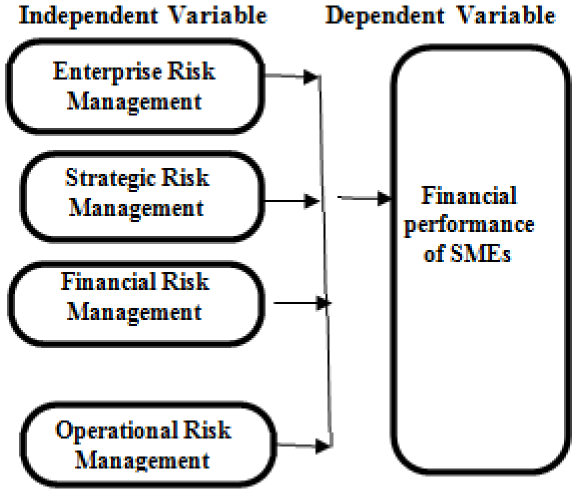
Rationality is the reasoning behind individual behavior. Individual rationality is dependent upon one's position within the organizational structure. Rationality connects individuals with organizations. For example, the way a junior officer perceives risk in the organization is different from that of a senior manager. Failure to attain a monthly sales target is seen as a high risk by a junior sales person than the Chief Executive. In short, organizational structure affects rationality and individual behavior.

In the application of the theory [28] posit that deviance was located in social processes rather than individual behaviour and that it could not be understood solely by investigating individuals. Becker suggested that instead of conceptualizing deviance as collective action it should consider all the parties involved. In a study of smoking initiation [28] define social practices as the reflexive activities that actors engage in that make and transform the world, the everyday activities that are continually being produced and reproduced. Analyzing smoking initiation in this way requires investigating where people smoke, where they obtain their cigarettes, how smoking is viewed and so on. With regard to this study the theory implies that SMEs should restrain from generalization of business practices and instead understand the organizational culture of each business and how it relates to the growth and development.

The First 1993 SME baseline survey in Kenya revealed that there were approximately 910,000 SMEs employing up to 2 million people. [29] estimated the size of the SME sector at 708, 000 enterprise employing up to 1.2 million people. Compared to other sectors of the economy, the SME contribution to the country's GDP increased from 13.8% to over 18% in 1999 (Sessional paper No.2 of 2005). Currently SME contribution to the GDP is over 25% [29]. [27] conducted a study to establish the impact of venture capital on growth of SMEs in Kenya. The study used 200 SMEs that have been financed by Venture capital as the target population. The SMEs were drawn from various major urban centers in Kenya. The study established that SMEs made significant growth after accessing the financing and recommended that other should do the same. The study also found that lack of finance has been stated as one of the main reasons for SMEs poor performance in most developing countries.

Business Partners International Kenya SME Fund found that profitability in SMEs grew by 79%**.** The average profit made by SMEs that had received funding from Business Partners International was KSh 4.7 million, whereas this had increased to KSh 8.4 million in 2011.

## 3. Conceptual Framework




## 4. Empirical Review

Small and Medium Enterprises (SMEs) is an important sub sector for the Kenyan economy like many other developing countries since it employs about 85% of the Kenyan workforce (about 7.5million Kenyans of the current total employment). The impact of devolution on SMEs development depends on the architecture of the regulatory and institutional framework inclined to support SMEs in an economy [30]. The contribution of SMEs in Kenya is more than double that of the large manufacturing sector, which stands at 7% of the GDP [30].

Overall, MSEs create 75% of all new jobs. Estimates show that, in the year 2005, the SME sector employed about 5,086,400 people, up from 4,624,400 in 2003 [23]. Employment increased by 462,000 persons and consisted of 74.2% of total national employment. The average income of enterprises surveyed was about Kshs.6,000 per month, or more than two times higher than the minimum legal monthly wage for unskilled employees, which in 2006 was Kshs.2,536. The share of the SME sector's contribution to GDP was estimated at18.4 percent. It is recognized that MSEs constitute a significant portion of the Kenyan private sector. Although statistics show that the SMEs sector is growing, there is high failure rate among individual SMEs which could be attributed to the risk management approach they take. [31] conducted a study on the impact of micro-finance services on the growth of SMEs in Kenya. The study targeted 50 SMEs in Nairobi. The researcher used self - developed questionnaire as an instrument of data collection and analyzed the data using quantitative analysis. The study established that SMEs largely depend on micro financing for growth. A significant percentage of SMEs was found to have access and do seek micro credit for their businesses. The study also established that microfinance services have assisted enterprises to change their status through growth in sales level from micro to small and from small to medium.

[28] conducted a study to find out the financial constraints that hinder growth of SMEs in Kenya. The factors hindering growth of SMEs were identified as capital access, cost, capital market collateral requirements information access, capital management and cost of registration. The study recommended that business financiers through loans consider reducing collateral requirements to facilitate SMEs

easy access to loans. However a report by the Business Partners International Kenya SME Fund [18] assessing the impact of the Fund on profit and employment in SME found that revenue had grown by 33%. The average revenue increased from Ksh 45 million in 2009 to Ksh 60 million. The report attributes the profit growth to a possible reduction in operation costs brought about by improved technology, which had been made feasible by access to funding and the use of the technical assistance facility.

In SMEs, profitability is calculated to determine relative performance of customer relationship. Banks into the IFCs benchmarking project in 2007 showed a great range of results in their ability to calculate profitability for their SME lines of business, these ranged from those that create a full set of financial statements to those only able to create a profit and loss account through to those not able to calculate profitability at all [32].

**Critique of the existing literature relevant to the study.**

Although their economic and social impact is important and they differ in many aspects from larger corporations, SME are not for long in the focus of researchers [34]. Most empirical studies about corporate risk management focus on large corporations. Publications regarding SME's risk management are seldom, although this is the size of the majority of companies [26]. Different researchers identified the missing focus on SME in the risk management research. For example, [33] has compared and analyzed 18 empirical research studies in 2006.He finds that the empirical research on corporate risk management has generally focused on large public companies, most often studying firms' use of financial derivatives. [33].

The overview of publications in International Small Business Journal, Journal of small business and enterprise development, Journal of small business management and Small Business Economics for the period 2000-2011 with the topic of risk management was subject of investigation. This investigation shows, that although 41 articles in those four journals about SME were published, which are somehow connected with risk, only 4 of them focus on risk management risks and financial risk factors of SME often in connection with their specific characteristics. However, the articles do not present possible forms of risk management, their requirements and ways of implementation for SME.

## 5. Summary

In general lacking expertise and knowledge about risk management can be observed in SME in the global context more so in Africa. One of the most important reasons for insolvency of SME is the lack in the ability to identify critical developments of their business. Risk management should be in the focus of SME and they should try to implement an easy and comprehensive risk management. Considering the contribution of the SME to the economy and the limited literature more so, on the effective risk management and performance of SMEs in Kenya, this study found it relevant to carry a thorough investigation on this matter.

## 6. Research Gaps

On average there are more SMEs closures than expansions with only approximately 1% of micro enterprises growing from five or less employees to ten or more. SMEs started in Kenya hardly grow to become medium or large enterprises; they remain static, while others die at an early stage. This implies that more than half of SMEs started do not achieve their intended goal. A survey conducted in Kenya, Nairobi by [22] reported that the main challenges facing SMEs are competition, insecurity, debt collection, and lack of working capital and power interruptions. Political uncertainty, cost of materials, low demand and restrictive by-laws completed the list of main challenges facing these businesses. Many SMEs have no risk management procedures in place and about a fifth of larger businesses also do not, suggesting that risk management is not totally embedded even among large businesses.

Majority of SMEs do not believe that adequate insurance for major risks precludes the necessity of regularly raising the issue of risks. Although there is a slightly greater inclination towards insurance among small businesses, there is a need for additional risk management strategies across the board. The ability of the management of SMEs to carefully identify the risks that their business could face and take actions accordingly to counter them will certainly lead to successful and profitable ventures and contribute to economic growth of the nation. By incorporating risk management into SMEs operations, SMEs are better equipped to exploit their resources, thereby enabling their organizations to transform an expenditure activity into an activity that can yield a positive return. There are no documented studies that have been done with regard to the effective risk management on financial performance of SMEs in Kenya. Thus this study found it relevant to investigate effect of risk on the financial performance of SMEs in Kenya.

## 7. Conclusions

From the literature and SMEs specific documents which were reviewed, it was observed that Risk management is a key contributor to financial performance of SMEs in Kenya. However, most SMEs do not embrace risk management as an important practice. Many SMEs look at risk management as a practice for large companies. Others know about risk but do nothing about it while others are ignorant about it.

## 8. Recommendations

1) The study therefore recommends that the management of SMEs should embrace RM at different levels in their organisations including strategic, financial and operational risk management as they are likely to uplift the performance of their organisations.
2) The management should leverage information technology in risk management by installing information systems that can carry out risk assessment & measurement more accurately and for monitoring their risk management programs for effectiveness. This should further be complimented by training of employees on risk

management policies of the firm, with clearly defined roles and responsibilities for risk management.

3) This study used secondary data which was limited to a few SMEs. Further studies should be carried out using primary data with wider coverage.
4) A deeper study should be carried out on the effect of specific risk management practices and ERM models adopted in other sectors in Kenya and the effect of this on their financial performance.

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