

Effectiveness of Risk Management in the MSME Sector: A Pilot Study

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Abstract

Enterprise Risk Management (ERM) is now accepted as an integral part of the organizational matrix in the MSME sector. While a lot of research has been undertaken in the field of risk management by financial institutions, very little effort has been made within India to understand the overall risk scenario in this sector. As MSMEs are the backbone of the economy, their sustained growth has always been the top priority of every government in the world. Due to their low capital base, inability to invest in technology, centralized decision-making, and lack of a structured ERM framework, the organizations have always been struggling and are observed to be highly susceptible to risks and vulnerable to business disruptions. Though ERM is in a nascent stage in India, it is widely practiced and the MSME sector, due to its exposure to the global marketplace, is no exception to it. This paper is a pilot study to understand the effectiveness of ERM and forms a part of the main study in the same area.

Keywords: MSMEs, Risk, Enterprise Risk Management(ERM), Effectiveness of ERM

Introduction

The Indian MSME sector has contributed substantially to the country's economy. Since India's economic liberalization in 1991, the sector has grown rapidly over the past three decades. Currently, it accounts for nearly 31% of the country's GDP and also accounts for nearly half of Indian Exports. This sector has always outperformed the Indian economy in terms of growth. Even so, it has its own problems to cope with. Largely family-dominated and traditional-minded, it continues to struggle to develop a sustainable business model (Annual Report 2021-22, MSME Ministry, Government of India). As the developed economies increase their sourcing from developing economies for their manufacturing and services, the technological, economic, and social disparity between them appears to be widening rather than shrinking (Gao, 2001). This, coupled with the increasing standardization of processes, has led Indian MSMEs to undertake ERM as an integral part of their organizational matrix.

Over the past couple of decades, a lot of research is being conducted all over the world to build successful and sustainable business models among the MSMEs through it. Due to its potential to generate employment at lower costs and its ability to transform the rural economic landscape, governments have always tried to support this sector (Bhatnagar, 2013). Since this sector is most susceptible to risks and disruptions emanating from them, ERM is generally perceived across the world as a remedy for its sustenance and growth. The key to developing an effective ERM framework lies in its proper implementation. This research paper aims to understand the way MSMEs identify, evaluate and treat risks; however, the most important part of the study is to understand whether they derive any benefits from ERM in today's era of rapid globalization and a dynamic business environment.

The universe for this study was Kolhapur, a small city in western India. With 800,000 inhabitants and an excellent infrastructure coupled with the existence of a long and successful legacy of MSMEs, it turned out to be a just choice for this study.

Objectives of the Study

As the title of this study suggests, this is a pilot study and, as such, forms a precursor to my main study, viz Effectiveness of Risk Management in the MSME Sector. On the backdrop of this, its prime objectives are:

1. To study the impact of Risks on the MSMEs
2. To understand the ERM processes practiced therein
3. To pinpoint the benefits, if any, of ERM

The Research Hypotheses are in keeping with these objectives.

Literature Review

The concept of ERM, though prevalent for decades, is relatively in a nascent state in India. As a result, the majority of the literature referred to was from abroad. Having studied more than 75 papers, theses, interviews, and articles, I have included the most relevant for this review. The most effective review comprises three steps:

- i. Planning the review
- ii. Conducting the review and
- iii. Reporting and disseminating the review (Tranfield et al, 2003)

The most important aspect of planning a review is the selection criteria for the literature to be reviewed. Most of the literature is from developed countries despite developing countries being more reliant on MSMEs for their industrial and economic development (Falkner & Hiebel, 2017). I have included the pioneer studies in the field as well as those undertaken in developing countries. While reviewing, I have tried to understand the evolution of ERM as a practice and its reflection on its effectiveness.

ERM generally consists of Risk Identification, Risk Assessment, Risk Treatment, and Monitoring and Reporting. Depending on the nature of an organization and the complexities involved in its products and processes, ERM can take specific forms. Clearly, it is of utmost importance to set the context of an organization as regards risks. Accordingly, ERM is a highly organization-specific activity (Hopkin, 2017). While the EU and China are the only major economies across the world that have issued ERM guidelines for the MSME sector, elsewhere in the world the practice is usually a reflection of the broader framework envisaged by the regulatory authorities in the respective countries for the corporates there. This makes it difficult for MSMEs to emulate those practices due to the reasons discussed earlier in the Introduction of this paper (Yakob et al, 2019).

The ERM process typically takes the following form (Figure 1):



Figure 1

Enterprise Risk Management (ERM) is an integrated process to predict, mitigate, handle, and reduce the impact of various risks (D'Arcy, 2001). As mentioned earlier, different organizations would follow the process in keeping with its suitability to their Risk Matrices. All researchers accept that risk is the product of the Frequency of Occurrence of an event and the Severity of its Impact (Henschel, 2008). Lately, there has been a lot of research in ERM in Europe and North America; however, in spite of the crucial role played by MSMEs in industrial, economic, and social development, little research has been undertaken in developing countries toward building a sustainable model for MSMEs' growth and success (Kanu, 2021).

Along with the changes in the nature of risks in the ever-dynamic business environment, the ERM process has also evolved in accordance with them. Emerging risks are the risks that can surface or are newly identified; these are the risks that are difficult to quantify or may culminate into huge losses. Frequent occurrences of natural calamities & disasters, climate

change, product/service liabilities, genetic engineering, and nanotechnology are seen as emerging risks (Kapur, 2018). Disruption risk, Reputation risk, and Collective risk management due to an increasingly globalizing economy as the focus areas of ERM. Another noteworthy aspect is the advent of technology in decision-making and behavioral aspects being another focus for ERM in the future (Deloitte, 2021). Data-driven risks, the role of top management in ERM-related decisions, and compliance with stricter regulatory requirements will be prominent activities across organizations (Unnikrishnan & Sivaswamy, 2022).

Pioneers researching this could not confirm ERM's benefits to an organization's performance. 'No effect' was observed to be the result of noisy data, immature ERM practices, and more significantly, the absence of an ERM performance matrix (Pagach & Warr, 2009). It was observed later that an uncertain environment, industry competition, organizational scale, complexities in products/procedures, and top management's indulgence were crucial aspects of the ERM leading to its intended outcome (Gordon, 2010). Top management's participation led to significant improvements in the effectiveness of ERM. Critical lacunae while deploying ERM and segregating functional risks in accordance with their assessment, evaluation, treatment, and monitoring. (Di Serio et al, 2011). Mitigation of potential risks, creating and nurturing intellectual capital & build-up of key resources, and focusing on innovation were observed to be decisive aspects of ERM regarding an organization's performance (Jafari et al, 2011).

Over the later years, ERM went on to evolve with the intent of being more applicable and relevant to the MSMEs' business objectives. Prompt detection of potential risks, management of change, and a comprehensive organization-specific ERM emerged as significant factors resulting in a robust ERM, and involvement of leadership, organizational scale, and complexity of products and procedures were observed to be means to achieve it (Ping & Muthuveloo, 2015). Top management's role is crucial as the inability to integrate ERM with a firm's overall functions across all levels is observed to be a decisive factor in ascertaining ERM's effect on a firm's performance (Callahan & Soileau, 2017). ERM as a practice cannot be deployed in a hap hazardous manner as its partial or lacklustre implementation is found to create no impact on such firms. In contrast, ERM-practicing firms are less susceptible to risks and exhibit better performances; from this, it can be concluded that ERM also helps reduce direct and indirect costs of risks (Florio & Leoni, 2017).

Lately, studies have become more result oriented. Mitigating risks in the global supply chain came in focus too. Mitigation of risks in the supply chain was observed to enhance an MSME's performance. With a freer and freer global business environment, MSMEs, especially in emerging economies, benefitted a lot from this opportunity (Hariharan & Sivasamy, 2018). As more and more firms from developing countries went on to become a part of the global supply chain, demand for a comprehensive ERM emerged as an important practice. In this scenario, the financial literacy of the leadership was observed to matter as it led to a significant impact of ERM and made the practicing firms globally competent (Yang et al, 2018). However, deploying ERM among all the functions of an organization and having a symbiotic relationship with all risk owners along with clearly defined risk ownership play a vital role in this process. Management of change and skilled manpower are critical aspects of the process (Adeyele, 2019). These observations clearly substantiate the belief that ERM definitely leads to improved performance of the MSMEs. Setting tangible objectives alone makes a big deal of difference to an organization's performance, while the internal environment, identification of risks, risk assessment, risk treatment, operational control, information & communication, and monitoring were found to make an insignificant impact. The major reason for this is found to be their lack of maturity coupled with inexperience in implementing ERM (Yakob et al, 2019). In smaller developing countries, paucity of capital and credit facilities, a shortage of skilled human resources, supply chain concerns, poor infrastructure, and the lack of ability to deploy the latest technology were observed as the factors hampering MSME performance. Techno-financial literacy of all the process owners can be the countermeasure to this (Kalathunga et al, 2020). ERM's effectiveness is directly correlated to the development of risk culture within the organization and strategic planning on the part of its management. There is no substantial evidence as of now supporting a linkage among these factors (Kanu, 2021).

Recent researches in this field always attempt to fill the void amongst the melee of previous research. Especially for new units, formulating their own ERM framework and its stringent monitoring is the new mantra. If the unit is thus monitored for the first 5 years, it is expected to have a better chance to sustain (Ghazali et al, 2022). ERM implementation adds value by helping firms to improve the price-earnings ratio and reduce the cost of capital by reducing information asymmetry among SMEs. ERM in SMEs should be able to provide solutions to minimize the risks that SME organizations are or are not exposed to (Poon et al, 2022). Size and the type of management of a company along with its age impact the performance of ERM among the MSMEs. Larger enterprises are observed to handle risks better. Economic, market, and business risks are important in the present business scenario (Buganova et al, 2023).

Research Methodology

The universe for this study is Kolhapur, India, located approximately 450 km to the southeast of Mumbai and 600 km to the northwest of Bangalore. The city has diverse industries like Foundry, Textile, Food Processing, and IT & IT Enabled Services. The city is well connected with the rest of India by rail, road, and air. Traditionally a foundry hub, the city has

blossomed with machining, textile, and other industries in recent decades. Of late, the service industry and IT-enabled services have also become a part of the city's economic landscape.

Data Collection

A detailed questionnaire was prepared to answer all the research questions and generate the necessary data for the research objectives and hypotheses. The respondents were either owner-managers or decision-making organizational heads in their respective organizations. This ensured the accuracy and authenticity of the data collected as they are responsible for the ownership of risks and, in most cases, also for risk treatment.

Population and Sample Size

Out of a total of 4,000 units, 200 are targeted for the main study. They are from such diverse sectors of the industry as Foundry, Machining, Textile, Fabrication, Food, Manufacturing, IT & IT Enabled Services and Other Services. This has ensured a comprehensive representation of the entire MSME sector in the periphery of the city. Out of these, 30 were randomly selected for this pilot study.

Research Design

The effectiveness of ERM is treated as the dependent variable. The independent variables were expected to influence the performance of MSMEs. Apart from these, I have tried to find the relationship between business disruptions and how businesses operate. Overall, I have framed 4 hypotheses that can lead to a constructive conclusion as regards the effectiveness of ERM as a practice in the MSME sector:

1. There exists a positive relationship between Risks and their impact on the MSME Sector in Organizational Management (H1)
2. There exists a positive relationship between Business Disruptions and the way businesses are operated (H1)
3. There does not exist a positive relationship between Risk Management and the performance of MSME units (H0)
4. There exists a positive relationship between the Risk Management techniques deployed by the MSME sector and business continuance as well as achieving business objectives in spite of several disruptions (H2)

As there is no structured ERM framework for the MSMEs in India, I have explored whether the sector is aware of the vacuum. On the sidelines, I have also attempted to understand whether governmental initiatives like Make in India and Atmanirbhar Bharat are instrumental in the development of the MSME sector.

Results

Descriptive Statistics

Out of the total 30 respondents, 12 were private limited companies, 9 were proprietorships, 8 were partnerships and 1 was a public limited company. It was found that 3 respondents had more than 100 employees, 4 had between 51 & 100, 6 had between 26 & 50, 11 had between 11 & 25, and 6 had less than 10 employees working for them. The oldest of the firms was established in 1953 and the youngest in 2021. On the front of the firms' turnover, 5 respondents had a turnover between ₹ 10 Crores to 50 Crores, 1 had between ₹ 5 to 10 Crores, 15 fell in the category of ₹ 1 to 5 Crores, 4 were in the band of ₹ 50 Lakh to 1 Crore and 5 were in the below ₹ 50 Lakh category. Standardization of processes is an important factor in ERM, hence I probed about their being certified with the various ISO standards. While 6 were not certified under any ISO standard, 22 were certified for the ISO 9001 (Quality Management System) standard, 1 for ISO 45000 (Health & Safety), 3 under ISO 27000 (Information Security Management System), and 1 under the HACCP (Hazard Analysis and Critical Control Points) standard. This has ensured a comprehensive representation of the industry in the geographical area under study.

Research Instrument

A carefully designed questionnaire was prepared and the respondents themselves filled it in during personal interviews. As mentioned earlier, this was necessary as the topic under study is among the least researched areas of study in India and practically unheard of in the selected area. In keeping with the Research Objectives and the Research Hypotheses, the questionnaire was framed so that the answers generated would be instrumental in answering all the Research Questions and help justify/reject the Research Hypotheses. The questionnaire was broken into parts thus:

- I. General Information of the respondent organization (11 questions)
- II. Circumstances giving rise to risks (7 questions)
- III. Perception & identification of risks (5 questions)
- IV. Impact of risks on the organization (4 questions)
- V. Risk Management Techniques and Risk Treatment (9 questions)
- VI. Effectiveness of Risk Management (7 questions)

VII. Role of the government (6 questions)
This made collating the data easier.

Reliability Analysis

The reliability of the questionnaire was ensured through the working of Cronbach's Alpha as it is regarded as a reliable method for validating the accuracy of a questionnaire. Cronbach's Alfa is calculated thus:

$$\alpha = Nc^-/[v^-(N-1)c^-]$$

Here N is equal to the number of items, c^- is the average inter-item covariance among the items, and v^- equals the average variance.

For this questionnaire, the ratio worked out to be 0.743. As it is between 0.7 and 0.8, it is acceptable for the research.

Correlation Analysis

This study aimed at finding out the relationship, if any, between the following:

1. Risks and their impact on the MSME Sector
2. Business Disruptions and the way the businesses are operated
3. ERM and the performance of MSMEs
4. ERM Techniques and achievement of business objectives

On the basis of these, the Research Hypotheses were postulated and interesting results emerged from the collected data. Following are the variables for all the Research Hypotheses:

Table 1 – Research Hypotheses

Independent Variables	Dependent Variables	Hypothesis
Risks	Impact on Business	There exists a positive relationship between Risks and their impact on the MSMEs (H1)
Business Disruptions	Changes in Operations	There exists a positive relationship between Business Disruptions and the way businesses are operated (H1)
Existence of ERM	Organizational Performance	There does not exist a positive relationship between Risk Management and the performance of MSME units (H0)
ERM Practice	Benefits from ERM Practice	There exists a positive relationship between the ERM deployed by the MSME sector and the benefits received therefrom (H2)

The degree of correlation is said to be low when the correlation coefficient is between 0.25 and 0.50. If the correlation coefficient is between 0.50 and 0.75, it is classified as moderate. If the correlation coefficient is above 0.75, there is a high degree of correlation. Table 2 above clearly states that business disruptions definitely have a positive relationship with the way businesses are operated as the coefficient thereof works out to 0.573. At the same time, Risks have a significant impact on businesses achieving their business objectives as signified by the correlation coefficient of 0.568. The correlation coefficient between the existence of ERM practice has a low degree of correlation with the organizational performance as the coefficient is 0.313. Interestingly, ERM has a relatively more, but still low relationship with the benefits received therefrom based on the correlation coefficient of 0.457.

Regression Analysis

Analysis of variance (ANOVA) was conducted for the set of variables. Following is the table showing the R, R^2 , Adjusted R^2 and the Standard Error of Estimate values:

Table 2 – Coefficient Results

Hypothesis No	R	R^2	Adjusted R^2	Standard Error of the Estimate
1	0.573	0.328	0.310	1.159
2	0.568	0.322	0.304	0.933
3	0.457	0.209	0.188	0.673
4	0.313	0.098	0.074	0.738

The R^2 value for the first hypothesis works out at 0.310. This signifies that Risks impact businesses to the extent of 31%. It means that there are other factors as well that impact them. For the second hypothesis, the R^2 value is 0.322. This signifies that the impact of disruptions on the way businesses are operated is 32.2%. Here too, other factors seem to make a heavier impact. The R^2 value for the third hypothesis is observed to be 0.209, signifying the influence of ERM on the firms' performance at just 20.9%. As for the fourth hypothesis, the R^2 value works out at 0.098, thereby meaning the influence of ERM on the organization being influenced by it is just 9.8%. Even on the background of this, it must be noted that Pearson's correlation does not tell us anything about the causal importance of the independent variables, especially in discrete data. The regression coefficients need to be examined to determine the impact of ERM implementation on SME performance (Poon, et al, 2022).

Table 3 – Summary of Hypothesis Testing

Hypothesis	Independent Variable	Dependent Variable	Std Error	Standardized Coefficient Beta	t	Sig.	Result
1	Business Disruptions	Change in the way business is operated	0.121	0.573	4.308	< 0.001	Accepted
2	Risks	Impact of Risks on businesses achieving their objectives	0.097	0.568	4.249	< 0.001	Accepted
3	ERM	Performance of the MSMEs	0.292	0.313	2.034	0.049	Rejected
4	ERM	Benefits of ERM	0.266	0.457	3.171	0.003	Accepted

In the light of the above, it can be concluded that:

H1 – Business disruptions do force businesses to change the way they operate; hence the hypothesis is accepted

H2 – The table clearly shows that businesses are impacted by Risks; hence the hypothesis is accepted

H3 – ERM definitely influences a firm's performance; hence the null hypothesis is rejected

H4 – A positive relationship exists between ERM and the benefits received therefrom; hence this hypothesis is accepted.

In short, it can be concluded that Risks affect businesses, forcing them to change how businesses are run and their business objectives at times. ERM can help them achieve their business objectives, the business disruptions notwithstanding, and certainly leads to an enhanced level of performance.

Conclusions

Findings

This study aimed at finding the effectiveness of Risk Management deployed by the MSME sector. The most important factor to be noted is that there are no guidelines specifically framed for the sector. As a result, businesses rely largely on their own expertise and, in the case of industrial units, on the ISO and similar other standards for the ERM guidelines. The MSME sector is traditionally family dominated and hence decision-making is generally concentrated within the families. The businesses usually have a low capital base which results in limitations on skill sets and keeping up with modern technologies. In recent years, Indian businesses have benefitted a lot from the government's strong focus on the sector's growth and the availability of finance or credit is not a major hindrance anymore. In the aftermath of the COVID-19 pandemic, they have reaped huge benefits from the global opportunities to which they had limited exposure earlier. The challenge now is to build up a sustainable business model and ERM is a decisive step in that direction.

Nearly all the respondents expressed a need for a regulatory ERM framework designed exclusively for the MSME sector. This is in keeping with the findings by Jayathilake (Sri Lanka, 2012). The researchers abroad generally refer to COSO guidelines issued by the Commission of Sponsoring Organizations of the American Trade Commission. These guidelines are not necessarily applicable or appropriate for other economies, let alone developing economies, as the business environment and regulatory framework there are not as omnipotent as in the USA. Such a framework could certainly help businesses become more sustainable in developing economies across the world.

Indian businesses have definitely benefitted from ERM even in the absence of a structured ERM framework. Most respondents stated that the major benefits of ERM for their organizations were improved profitability, achievement of their business objectives, and avoiding business disruptions. Almost all believed that their organizations' performance has

improved due to ERM. Interestingly, only one respondent reported that there was no change in ERM deployment during the past disruptions. The rest had to change their ERM practice during that phase. In the same vein, just 9.3% said they didn't have to change their business objectives due to disruptions. The rest were largely forced to change them.

In the ERM process, most businesses reported that the identification of risks is mainly done by stakeholder management, inputs from operations, and inputs from end users. Evaluation of risks is largely done through their impact followed by customers' guidelines and expert's/consultant's advice. It is important to note that all these entities are external. Risk treatment mainly comprises risk mitigation and risk acceptance followed by risk transfer. A large majority believed that risk avoidance is rarely chosen simply because the choice is unavailable. This leads to the conclusion that ERM practiced by MSMEs in India is still in a nascent stage and is more of a reactive nature than proactive. Organizations are not prepared to handle more and more tightening regulatory risks as well as globalization-related, technological, and supply chain-related risks. This is in cohesion with Saeidi et al (Iran, 2020).

In conclusion, ERM is observed to have a direct impact on the performance of MSMEs and can help them achieve their business objectives in spite of predictable and unpredictable disruptions. A structured ERM regulatory framework could help the sector build a robust and sustainable business model in the increasingly competent, dynamic, and stringent business environment over the coming decades.

Limitations

This study was focused on the effectiveness of risk management. As the data was collected through lengthy personal interviews with the decision-makers, it can be safely said that it had the maximum possible accuracy. However, in the absence of a specific framework for the same, the data collected turned out to be highly individualistic and sporadic in nature.

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Conflict of Interest

I declare no conflict of interest with any entity in this study.

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