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Leaders and financial risks in small and medium enterprises

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Abstract This paper focuses on the issue of leaders and financial risks in small and medium enterprises (SMEs). Business leaders who are often the managers or owners of small enterprises are the first to face the risk and to suffer most severely from their outcomes. Thence, they need to be aware of all possible risks coming their way and to indicate them properly and in time.
Nowadays, small companies mostly appear to suffer from operational risks and financial situation. We demonstrate that there is a need for instruments to promote and support the economic recovery of the SMEs in the European Union (EU) and several countries outside the EU. The central question at this point is whether they should be maintained once the recovery has fully stabilized. In terms of guarantees, we need convincing arguments as to why extending credit risk to taxpayers can lead to a solution to structural market failures.
We employ the empirical model that reports the results of the econometric analysis of opinions of Slovak leaders regarding the highest financial risk in small and medium enterprises from Slovak Republic. Our results show that poor payment discipline of business partners and the dysfunctional capital market both constitute the highest financial risk for small business companies.

1 Introduction

Most small and medium enterprise (SMEs) think of the financial risks only once a year with regard to their annual tax and balance sheets. Most of them do not even know how to deal with general business risks, not speaking about the complexity of the financial markets and its derivates (Rostamkalaei and Freel 2017; Bialowąs 2018).

As the credit crunch continues in many cases and due to a plethora of reasons, SMEs revenues decline and margins shrink, many small businesses face bankruptcy. Fluctuations in the interest rate, exchange rate and inflation rate have serious implications for operational efficiency, losses from foreign trade or foreign trade, or even late payments from major customers (Moskalenko and Yevsieieva 2015). These have also resulted in many small businesses being exposed to massive debt (Janda et al. 2013).

SMEs might constitute the backbone of the economy, employ a considerable amount of labour force, and comprise the largest family of enterprises in many countries, most notably in some southern countries, but, in the same time, they are the most vulnerable business companies to any financial risks due to the nature and the scope of their operation (Abrham et al. 2015; Šabić-Lipovača et al. 2016).

In addition, there is also cyber risk which represents the risk of financial loss, disruption or reputational damage to a business due to a failure of its information technology (IT) systems (Garg et al. 2003). Nowadays, when almost all companies go cashless and use Internet banking, payment with credit cards or through the Internet are the must for the successful small businesses. At the same time, companies are collecting more personal information from their customers. The best advice for any new business owner is to formalize risk management right from the start. Good and balanced risk management protects the company's reputation and helps in planning contingent liabilities. This also should be coupled with a good financial literacy that would involve dealing with the simplest yet threatening issues of financial cyber crimes such as phishing or hacker attacks.

In this paper, we aim to classify the most profound financial risks to the small and medium enterprises using the empirical model based on the interviews with small business owners – i.e. the people who run their SMEs on a daily basis and face all the threats and shortcomings of being small business owners. These people rarely receive help and financial advice from the government and specialised agencies. Most often, they have to encounter all the pros and cons of being small entrepreneurs on their own.

This paper is structured as follows: Section 2 describes the financial risks in SMEs and existing for SMEs on the market. Section 3 features the empirical model based on the analysis of the survey conducted with a random sample of 438 leaders from Slovak SMEs. Finally, Section 4 provides some conclusions and policy implications for stakeholders and policymakers.

2 Financial risks in SMEs

One would probably agree with the statement that small and medium enterprise do not have an easy access to various investment opportunities such as private equity may only be available to institutional investors or individuals with high wealth, sophistication and other resources such as mentoring (Cowling et al. 2015). An investment management firm prepares a collective investment fund with a defined investment strategy and markets the fund to the public.

The financial management data gaps remain significant and further efforts could be made to improve the collection of financial management data and evidence. Firstly, the SME population is very heterogeneous, and the financial challenges differ significantly from various parameters such as the age of the enterprise, its size, location, sector, growth potential and main contractor characteristics such as gender or business experience (Zamfir et al. 2017). Despite the widespread recognition that policies must be tailored to the diverse needs of the business population, data collection efforts do not always capture detailed information based on these parameters. Social initiatives, such as offering a health and additional benefits package to your employees or improving the accessibility of your facility, must also be considered in your budgeting process. In many cases, the financial benefits of improving work ethic, staff retention, and market share may only be achievable in the long term, and often in a very intangible way, making quantification difficult. Companies that incorporate social and environmental factors into their business processes and financial analysis often take longer payback, payback, end-of-life or lifecycle issues into account and add stakeholder interests.

Cheng et al. (2014) use a sample of over two thousand listed companies to show that companies with better corporate social responsibility (CSR) performance are faced with significantly lower capital restrictions. Importantly, the authors find that comprehensive CSR reporting creates a positive feedback loop, as increased transparency about governance structures can result in positive changes in their internal control systems and further improve compliance and reporting reliability. In addition, increased transparency and availability of data on a given company will reduce information asymmetry between companies and investors to ensure better access to finance (Cheng et al. 2014). Moreover, Vial and Hanoteau (2010) also find a positive relationship between corruption, output and labour productivity. In addition, Healy and Serafeim (2015) conducted a survey of almost five hundred major multinationals and found that companies with weaker integrity mechanisms are seeing higher sales growth in high-risk markets, but readiness for bribery carries additional costs to return and might lead to company failure.

In other words, while more corrupt large multinational companies may generate higher sales in riskier markets, they will become less profitable as the additional cost of paying for bribes will not be fully covered by higher prices or higher sales. Companies that are committed to reducing their environmental footprint and delivering positive benefits to the community enjoy a reputation as a good company among employees, customers, suppliers, investors, and community members (Grewal et al. 2017). Reducing the regulatory risk of fines, shortening time, understanding and complying with regulations, and anticipating new regulations is just good management. For example, many companies are working to reduce their energy consumption and CO2 emissions. They expect to soon enact regulations that force companies to pay for their emissions.

Other companies are seeking to improve health and safety conditions in the workplace in order to reduce regulatory burden. There are many social challenges that hinder the promotion of sustainable development, including poverty, unemployment and social exclusion, as well as social problems related to security, inequality, health and working conditions. The obvious social role of enterprises is job creation, where companies can directly reduce poverty and promote economic and social development through the jobs they create. However, there is a global consensus that companies have a greater social mandate than job creation and the payment of taxes. Companies that are in contact with their community and other stakeholders can take advantage of new market trends and innovation opportunities. Through networking and other community contacts, companies are likely to generate new business ideas, sales leads, and opportunities for partnerships. Businesses hiring immigrant workers can leverage their international networks, skills, communities and languages, giving the business a local and global competitive advantage. Digital technologies are changing distribution models as customers increasingly expect online and mobile access and financial and technical assets appeared throughout the financial value chain. For micro and small businesses, digitization significantly reduces the overall cost of migrating transactions (and thus bank costs) from the traditional branch network to highly scalable online and mobile platforms (Klapper and Singer 2017).

In general terms, a capital market can be either a primary market or a secondary market (see e.g. King 2018). In the primary market, new shares or bonds are sold to investors, often through a mechanism called a subscription mechanism. Governments only issue bonds, while companies often issue both stocks and bonds. Key companies that buy the bonds or shares include pension funds, hedge funds, sovereign wealth funds, and less affluent individuals and investment banks that trade on their own behalf.

In the 20th and early 21st centuries, many governments used investment banks to organize the sale of their bonds (see Bordo et al. 2015). The leading bank subscribed to the bonds and often led a syndicate of brokers, some of which may have been located in other investment banks. For developing countries, a multilateral development bank sometimes provides an additional level of subscriptions, which results in sharing the risk between the investment banks, the multilateral organization and the final investors. However, since 1997, it has become increasingly common for larger-nation governments to bypass investment banks by offering their bonds directly online which is the new practice even small businesses have to comply with.

3 Empirical model

For our empirical model that is envisaged to assess and analyse the perception of financial risks in SMEs , we collected a sample of 438 leaders (managers and business owners of SMEs) from small and medium enterprises located in various parts of Slovakia.

Slovakia has not been chosen on random – the country can boast a considerable SME community in such sectors as tourism, rural development, and agricultural goods processing (Mura and Ključnikov 2018). The leaders were selected using the random sampling techniques and their opinions on highest financial risk in SMEs were registered. Interviews were conducted with all respondents in the sample and the results were recorded and carefully analysed.

Most of the leaders, almost half of them (42.2 % of the leaders represented by the respondents in our sample) considered that the highest risk for the Slovak SMEs was the poor payment discipline of business partners. About 22 % of the interviewed leaders considered that the highest financial risk is the poor state support to enterprises. Only 5.9 % of the people considered that the main risk for SMEs in Slovakia is the dysfunctional capital market. The poor access to financial sources is claimed to be the hardest problem for 11% of the leaders represented by the SMEs managers and owners (see Table 1 that follows).

Table 1. The distribution of leaders according their options regarding the highest financial risks for Slovak SMEs

		Frequency	Percent (%)	Valid Percent (%)	Cumulative Percent (%)
Valid	1. dysfunctional capital market	26	5,9	5,9	5,9
	2. poor access to financial sources	48	11,0	11,0	16,9
	3. poor state support to enterprises	97	22,1	22,1	39,0
	4. poor payment discipline of business partners	185	42,2	42,2	81,3
	5. difficulty to obtain credit resources	47	10,7	10,7	92,0
	6. poor awareness of entrepreneurs on funding opportunities	35	8,0	8,0	100,0
	Total	438	100,0	100,0	

Source: Own results

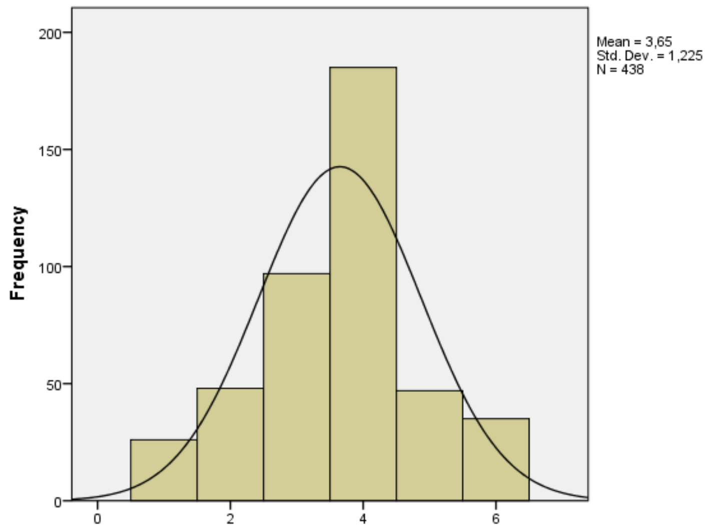

Fig. 1. Histogram for the options of leaders regarding the highest financial risk for Slovak SMEs
Source: Own results

Figure 1 that is shown above reports the histogram of the results of answers to the question: “Please indicate which of the following financial risks do you think is the biggest for Slovak SMEs?”. One can note that risk number 4 (debt recovery) prevails in all answers.

Moreover, running more tests using our data, it appears that there is not a significant relationship between leaders’ opinions regarding the most important financial risk and gender, at 5% level of significance (see Table 2). Both female and male leaders perceive financial risk equally and both consider it a big problem and issue.

Table 2. Chi-square tests for checking the association between the highest financial risk for Slovak SMEs according to gender

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	18,042[a]	5	,003
Likelihood Ratio	17,698	5	,003
Linear-by-Linear Association	,552	1	,457
N of Valid Cases	438		

Symmetric Measures

		Value	Asymp. Std. Error[a]	Approx. T[b]	Approx. Sig.
Interval by Interval	Pearson's R	,036	,052	,743	,458[c]
Ordinal by Ordinal	Spearman Correlation	,027	,051	,557	,578[c]
N of Valid Cases		438			

a. Not assuming the null hypothesis.
b. Using the asymptotic standard error assuming the null hypothesis.
c. Based on normal approximation.
Source: Own results

Overall, the chi-square test indicated a linear significant association between leaders’ options regarding the highest financial risk and their age at 5% level of significance (see Table 3). It appears that all managers and owners of the SMEs perceive financial risk in a similar, or at least, comparable way, regardless of their age.

Table 3. Chi-square tests for checking the association between the highest financial risk for Slovak SMEs according to age

	Value	Df	Asymp. Sig. (2-sided)
Pearson Chi-Square	24,566	10	,006
Likelihood Ratio	24,457	10	,006
Linear-by-Linear Association	3,855	1	,050
N of Valid Cases	438		

Symmetric Measures

		Value	Asymp. Std. Error[a]	Approx. T[b]	Approx. Sig.
Interval by Interval	Pearson's R	,094	,047	1,970	,049[c]
Ordinal by Ordinal	Spearman Correlation	,080	,047	1,671	,095[c]
N of Valid Cases		438			

a. Not assuming the null hypothesis.
b. Using the asymptotic standard error assuming the null hypothesis.
c. Based on normal approximation.

Source: Own results

All in all, it appears that most of the leaders in each age category considered poor payment discipline of business partners as the most important financial risk. Another risk that was mentioned by the fewest part of the leaders in the sample was represented by the dysfunctional capital market in the country.

4 Conclusions and policy implications

Overall, our results and outcomes show that financial risks in SMEs might be quite significant. Nevertheless, it is often up to small business owners and managers to identify and to tackle these risks.

Our results show that issues such as dysfunctional capital markets do not bother SMEs owners much. It is the trust in business partners and the payment discipline (or the proper financial behaviour) of the business partners that constitutes the main financial risk in the eyes of small business leaders.

When it comes to the policy implications, one might advice to the policymakers and stakeholders who are in charge of promoting and fostering small business in their respective countries to concentrate on building a healthy financial and business environment where the rule of law plays the key part. Trust to the instruments of the state that might enforce justice in financial flaws and payments seem to be very significant here. Moreover, it might be useful to take care of the issue of financial cybersecurity, since most small and medium companies operate via Internet payments and need to be absolutely sure about their safety and protection. Even small frauds and problems might mean the end for a small SME, thence good measures and security protocols need to be installed for establishing the proper financial security.

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