Developing Country Studies
ISSN 2224-607X (Paper) ISSN 2225-0565 (Online)
Vol.3, No.8, 2013 

# Risk Management as a Conduit of Effective Corporate Governance and Financial Performance of Small and Medium Scale Enterprises

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**Abstract**
Previous attempts to measure the quality of corporate governance tend to focus on inputs of governance such as the separation of the CEO and the chairman's roles and the composition of boards, largely based on the agency theory. The purpose of this paper is to examine the extent to which risk management can be incorporated into the corporate governance framework on the backdrop of stewardship theory. After reviewing some of the key issues from literature, the paper demonstrates how relevant risk management practices are to the governance of the SME sector. It also made clear that both corporate governance and risk management have a positive relationship with financial performance. In the end, it advocates for the need for both practitioners and researchers to pay attention to issues of risk management when analyzing the extent to which corporate governance principles are being adhered to by business organizations.
**Keywords:** Risk management, corporate governance, financial performance, SMEs, Ghana

## 1. Introduction

The landmark study of Berle and Means (1932) laid the foundation for further studies on the concepts of corporate governance and risk management. The thrust of their argument was that those who legally own business organisations have been separated from their control. Therefore, corporate governance and risk management must be established to ensure the presence of systems and institutions to direct the way companies are governed to limit the risk of business failure and the abuse of financial resources.

Later, Ross (1973) and Jensen and Meckling (1976) founded the agency theory. The notion of the theory is that in the presence of information asymmetries and self-seeking behaviour in the real world of business, individuals would use informational and other advantages to transfer wealth to themselves from others. Early attention on such behaviour, however, focused on conflicts of interest between shareholders and managers (Berle and Means, 1932) on one hand, and shareholders and bondholders on the other. Later, other stakeholders were brought into the scheme. Ways of solving these conflicts are the concerns of both corporate governance and risk management. Nevertheless, within the context of Small and Medium Scale Enterprises (SMEs) the motivation to adapt these concepts may not necessarily be due to the 'agency problem' because of the underlying attribute of the rareness of the separation between ownership and management, especially in developing economies (Yacuzzi, 2005; Clarke, 2006). Owner-managers of such enterprises are expected to be altruistic and so manage the affairs of the business to best of their abilities to meet both their expectations as well as those of other stakeholders. The stewardship and stakeholder theory therefore becomes the main theoretical bases for studies on corporate governance in SMEs. Stewardship theory argues that management do not behave opportunistically, but rather wants to do a good job and therefore rejects the lack of trust between shareholders and managers as advanced by agency theory. While the stakeholder theory addresses the need to balance the claims of shareholders with those of other stakeholders (Ruf et al, 1998). Empirically and theoretically, both corporate governance and risk management have an influence on financial performance of organisations irrespective of their size.

The issue of corporate governance has been a growing area of management research especially among large and listed firms (Abor & Adjasi, 2007). The limited studies (For example, Abor & Biekpe, 2007; Kyereboah-Coleman & Amidu, 2008; Al-Najjar, 2009; Hamad & Karoui, 2011; Gill, Mand & Mathur, 2012) that have been conducted this far within the SME sector have been based on agency theory and thereby relied largely on indices applicable to large and well-resourced firms. It is crucial to examine corporate governance in the SME sector from the context of a developing economy with the view of highlighting the relevance of risk management and other sector-specific indices as important measures of effective corporate governance. Clarke (2006) recommends the need for specific and simple SME governance arrangements that reflect their particular form and architecture. These forms include the predominance of family based firms with a strong crossover between managers and owners. According to the author, this provision should also recognize the largely fictional notion of separation in SMEs that is, in fact, more apposite for large and listed firms. Among other variables, Garg and Weele (2012) postulated risk management as an important measure of corporate governance in SME studies.

 

Therefore, this paper theoretically examines the relationship between good corporate governance and risk management, the need for the extension of corporate governance indicators to include risk management in SME studies and the impact both concepts will have on financial performance. The discussions are done with respect to the Ghanaian SME sector given the important role they play in the economy.

The Ghana Statistical Service (GSS) viewed firms with less than 10 employees as Small Scale Enterprises and their counterparts with more than 10 employees as Medium and Large-Sized Enterprises. In Ghana, this sector is viewed as a significant source of employment creation and national revenue through taxation (Kayanula & Quartey, 2000; Keskin, 2006; Abor & Quartey, 2010). Abor and Quartey (2010) posit that SMEs contribute about 75% to Ghana's GDP and also account for 85% of employment in the manufacturing sector. But more importantly within the context of development, a growth in this sector has a relationship with poverty alleviation (Landes, 1998; Gebremariam, Gebremedhin & Jackson, 2004).

## 2. Corporate governance and risk management

Corporate governance and risk management are interrelated and interdependent. The sustainability of company's performance is highly depended on the effective role of both concepts. The element of control is one of the corporate governance roles, while a controlled environment is developed from the risk management process (Knight, 2006). Thus, Knight (2006) defined corporate governance in relation to risk management as the medium by which an organization is governed and controlled in order to achieve its objectives. The controlled environment makes an organization reliable in achieving these objectives within an acceptable degree of risk.

Risk management is an effective technique for minimizing undesirable effects of risks and optimizing the benefits of risky situations (Essinger & Rosen, 1991). Chapman (1997) describes the aim of risk management as process enhancement that is established through systematic identification, evaluation and mitigation of project risks. The function and objective of both corporate governance and risk management is to maximize shareholder value (Sobel & Reding, 2004; Busco, Frigo, Giovannoni, Riccaboni, & Scapens, 2005). They are connected to assist organizations to better understand risks, to improve and deliver its objectives and to mitigate, assess, and manage risk in an appropriate manner (Manab, Kassim & Hussin, 2010).

Recent accounts on company failures, corporate scandals, and frauds are among the reasons for companies to effectively implement risk management programmes. These companies' failures have been blamed on poor risk management and corporate governance. For example, in the East Asian financial crisis in 1997, weak corporate governance and poor risk management have been found as the main factors of companies' failure (Mitton, 2002).

## 3. Risk Management and financial performance

In a perfect capital market with no asymmetric information, risk management at the firm level should be a negative NPV project (Pagach & Warr, 2010). However, Stulz (1996, 2003), Nocco and Stulz (2006), Wang and Reuer (2006) and Andersen (2008) present arguments under which risk management activities could be value increasing for a firm and its stakeholders when agency costs, market imperfections and information asymmetries interfere with the operation of perfect capital markets. Stulz (1996, 2003) argues that any potential value creation role for risk management is in the reduction or elimination of "costly lower-tail outcomes." Lower tail outcomes are primarily negative earnings and cash flow shocks and can have both direct and indirect costs. Direct costs are incurred in events such as bankruptcy and financial distress when the firm must make outlays to creditors, lawyers and courts. Indirect costs of associated with negative earnings and cash flow shocks, include the loss of reputation that may affect customer and vendor relationships.

In addition, indirect costs hamper the ability to pursue profitable growth options, and the ability to realize the full value of intangible assets upon liquidation. A decline in debt ratings and the resulting increase in borrowing costs can also be costly for shareholders in that previously positive NPV projects may now have to be foregone. Direct costs also include the costs associated with missing earnings targets and violating debt covenants.

Stulz (1996, 2003) further argues that risk management can be value creating if it is able to reduce the likelihood of these negative earnings shocks and in turn, help the firm avoid the direct and indirect costs associated with financial distress. Similarly, Wang and Reuer (2006) postulate that risk management can persuade stockholders to invest in companies specific assets. These resources include processes of producing specific products or using certain technologies in industries that use knowledge for productions and services. In addition, such investments that are caused by employees, suppliers, customers and partners are a kind of financial resource that are often rare and valuable and are basis for higher economic value and gaining competitive advantage. Anderson (2008) concluded that risk management reduces a firm's average capital expenditure and contract costs as it eases access to resources.

In a 2005 article, in which Tagoe, Nyarko and Anuwa-Amarh assessed the effect of financial sector liberalization policies on the financial management of SMEs in Ghana, using six case studies, they found that the decision of investors to invest in SMEs depends on their perception of risk concerning these firms and other available alternative investment opportunities. These findings suggest that risk management enhance SMEs access to credit and consequently improve their financial performance.

## 4. Corporate governance and Financial Performance

Poor governance systems have been identified to have thwarted efforts of SMEs at attracting finance and thus are deemed to be one of the main barriers to their performance (Gockel & Akoena, 2002; Abor & Biekpe, 2007). Abor and Biekpe (2007) reasoned that the perception of higher risk, informational barriers, and the higher costs of intermediation for smaller firms explains the reluctance of financial institutions to advance credit to SMEs.

Dube, Dube and Mishra (2011) reported that good governance improves SMEs' prospect of obtaining funds from banks, investors and venture capitalists. They also contend that firms that have greater transparency or information disclosure tend to have healthier growth rates and ratios of ordinary profits to that of capital, than firms who do not do so. Hence, corporate governance has a role in SME performance since it improves transparency and attracts capital at a cheaper cost (Spanos, 2005; Yurtoglu & Claessens, 2012).

According to Spano (2005), corporate governance has significant implications for the growth and development prospects for even the overall economy, because proper corporate governance practices reduce risk for investors, attract investment capital and improve performance of companies. Claessens (2003) identified several channels through which corporate governance influences growth and development. The first is the increased access to external financing by firms. This in turn can lead to larger investment, higher growth, and greater employment creation. The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment. The third channel is better operational performance through better allocation of resources and better management. This creates wealth more generally. Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises can have large economic and social costs. Fifth, good corporate governance can mean generally better relationships with all stakeholders. This helps improve social and labour relationships and aspects such as environmental protection.

Considerable evidence further exists to establish the link between access to credit and improved performance of SMEs (Kasekende & Opondo, 2003; Brown & Caylor, 2006; Su & Sun, 2011; Dube, Dube & Mishra, 2011; Nakiyingi, 2012). For example, Brown and Caylor (2006) found a higher valuation, higher profitability and higher dividends payments for better-governed firms. Therefore, corporate governance is hypothesized to have a relationship with the financial performance of SMEs.

Some empirical studies in Ghana have established a relationship between measures of corporate governance and financial performance. For instance, Abor and Biekpe (2007) sought to assess how the adoption of corporate governance structures affects the performance of SMEs (small to medium-sized enterprises) in Ghana. Regression analysis was used to estimate the relationship between corporate governance and ownership structure and performance. The study showed that board size, board composition, management skill level, CEO duality, inside ownership, family business, and foreign ownership have significantly positive impacts on profitability.

A year later, Kyereboah-Coleman and Amidu (2008) set out to examine corporate governance practices of SMEs in Ghana and whether there is any linkage between these governance practices of SMEs and financial performance. They employed two levels of interaction to achieve these objectives: The first was an interview for a general understanding of governance issues in the SME sector and the subsequent design of a questionnaire for an exploration of the linkages between governance issues and firm financial performance by employing a linear model.

The study revealed that governance structures in SMEs were jointly influenced by credit providers and business ethical considerations. The regression results showed that board size, size of audit committees, corporate ethics and the proportion of outsiders on the audit committees have negative impact on financial performance while independence of the board and the presence of audit committees enhance firms' financial performance.

## 5. Conclusion

The significance of corporate governance cannot be over emphasized as it creates the necessary organizational setting for the internal operations of a business enterprise. The implementation of corporate governance canons among SMEs can result in better management practices, stronger internal auditing and greater opportunities for growth. The issue, however, is that the known indices of corporate governance employed in larger firms such as board composition, CEO tenure and duality and so on are not be applicable to SMEs, especially in developing economies. This paper established the link between risk management and corporate governance as well as the relationship between risk management and financial performance in order to advocate for the inclusion of risk management as a measure of an effective corporate governance practices by both practitioners and academic researchers. A consistent track record of effective risk management just like corporate governance will greatly assist SMEs when it becomes necessary to solicit for external funding. This paper also argues that risk management have a positive effect on the financial performance of business organisations and must therefore be pursued. It must be noted that both good governance and risk management do not automatically guarantee business success. However, their absence could be indicative of a business failure.

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