Enterprise Risk Management Framework for Small and Medium Enterprises

Bhavana Umanath, A.N.Santosh Kumar

Abstract*: *In today's profoundly unpredictable business environment, managing the risks effectively is a stumbling block for almost all the organizations. A diverse range of risks are faced by every organization, both from internal and external sources. The small and medium enterprises in India are exposed to a plethora of risks. Adapting to an Enterprise Risk Management framework will proactively help in reducing the exposure to risks and mitigate them. In this regard, this paper discusses about the role of SMEs in Indian economy, the common risks faced by them, the components of COSO ERM framework and its benefits to SMEs by implementing them.

Keywords*: *COSO framework, Enterprise risk management, ERM frameworks, Small and Medium Enterprise.

I. INTRODUCTION

The small and medium enterprises sector has been identified as the engine of economic growth in India due to their major contribution. According to the Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 as per the Annual report 2017-18 [1], Micro, Small and Medium Enterprises (MSME) are classified based on their investment in plant and machinery for the manufacturing sector and their investment in equipments for the service sector. Recently, the Union Cabinet has approved the proposal for changing the classification criteria for MSMEs keeping in mind the ease of doing business in the country. This new proposal categorises the MSME based on their annual turnover. The proposed classification is as shown in the table-1:

TABLE I. EXISTING AND PROPOSED CLASSIFICATION OF MSME

Classification	**Existing** *(As per Investment in Plant and Machinery / Equipments)*		**Proposed** *(As per Annual Turn Over)*
	Manufacturing Sector (Investment in Plant and Machinery)	Services Sector (Investment in Equipments)	Common for both Manufacturing and Services Sector
Micro Enterprises	Upto INR 25 Lakhs	Upto INR 10 Lakhs	Upto INR 5 Crore
Small Enterprises	Over INR 25 Lakhs and under INR 5 Crore	Over INR 10 lakhs and under INR 2 crore	Over INR 5 Crore and under INR 75 Crore
Medium Enterprises	Over INR 5 Crore and under INR 10 crore	Over INR 2 crore and under INR 5 Crore	Over INR 75 Crore and under INR 200 Crore

Source: Press Information Bureau, Government of India. Ministry of Micro, Small & Medium Enterprises, Feb 7th 2018 [2].

II. ROLE OF SMEs IN INDIAN ECONOMY

According to the 12th 5 year Plan (2012–17) report of the Working Group on MSMEs growth [3], it is disclosed that, when considered regarding the value, this sector is responsible for 45% of the output given by manufacturing and 40% of the overall exports of the country. It is also highlighted in the Annual report 2017-18 [1], that the contribution of MSMEs is 28.77% in the GDP for the year 2015-16. The contribution of SMEs plays a critical part in promoting a balanced economic growth in the country. It is also successful in attaining socialistic goals of furnishing equitable growth.

III. RISKS FACED BY SMEs

Despite having a high growth rate and good prospectus, the SMEs, which are considered to be the backbone of India, are vulnerable to risks due to the lack of resources required to respond to the threats. This could lead to tremendous losses that question their survival.

As per the study conducted by Sonia Mukherjee [4], the most prominent challenges faced by SMEs are

1. Procurement of raw materials at reasonable costs
2. Lack of timely credit
3. Insufficient facilities of infrastructure
4. Difficulty in finding manpower with required skill sets
5. Backwardness in the recent technological developments.

Lap Duong [5] in his study mentions that risk is present everywhere and spreads through every aspect of life. Unexpected circumstances can cause serious losses to any business sector. Especially in case of SMEs, since the capital background is not strong, a disaster can cause disturbance in all the activities.

Therefore a risk management practice to minimise the exposure to loss becomes very important for SMEs. It is of utmost importance to progress towards the development of the SME sector by making them adapt to strategies and methodologies of risk management.

IV. ENTERPRISE RISK MANAGEMENT

Enterprise Risk Management is a systematic approach of managing the overall risks which an organization faces.

James W. De Loach [6] in his book on Enterprise-wide Risk Management posits ERM as an organized approach which brings together the processes, employees, strategies involved and technology with the intention of assessing and handling the risks faced by the enterprise during its

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continuous growth. It is an integrated and progressive approach which manages all the dominant risks faced by the business and also opportunities in order to increase the shareholder value for the organization.

The Traditional Risk Management is silo based whereas ERM emerges as a practice that effectively overcomes the limitations of the latter. Risks are viewed as individual hazards by Traditional Risk Management, whereas ERM considers risks in view of business strategy and builds a portfolio for the development of risk.

Gatzert and Martin [7] in their study have expressed that the intention of ERM is not just minimization of risk but also considers the probable opportunities explicitly.

By practicing Enterprise Risk Management, the capacity of an organization to manage risks effectively is enhanced. Whatever may be the size of the organization, ERM brings out a methodical approach to identify, measure, prioritize and in turn respond to the risks.

V. COSO's ERM FRAMEWORK

An effective Enterprise Risk Management Framework was released by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2004 in order to help the businesses to improve their risk management practices and also improve the control process internally.

COSO Framework [8] mainly outlines eight inter-related components of ERM which are:

- **Internal environment** – This component incorporates the role usually played by the organization's board of directors in initiating risk management ideology and governance. Also this component includes the idea of risk appetite. ERM and governance framework is the base for building the direction of risk tolerance put forward to the senior management by the board and to the operating management by the senior management.
- **Objective setting** – An organization's risk appetite is understood and expressed by this component while the business objectives are set and being communicated.
- **Event Identification** – The probable events that may affect the organization must be identified by the board. This includes identifying events from sources which are within or outside the organization and which influences the accomplishment of objectives.
- **Risk Assessment** – Once the risks are identified, they are analyzed to decide the way of managing them. Risk assessment is a continuous process and needs to be carried out all though the organization.
- **Risk Response** – The idea that the management has diverse alternatives for reacting to a risk is embedded in this component. The option chosen by the management should be communicated to the board to enable the directors to carry out their governance oversight responsibilities.
- **Control Activities** – In order to make sure that the risk responses and other directives of the organization are carried out well, suitable policies and procedures are set up.
- **Information & Communication** – Communications in different directions within the ERM and governance framework bridges the gap between them.
- **Monitoring** - The board of directors is in charge for monitoring the effectiveness with which the management carries out governance established by the board. This is an important component of ERM and governance model.

The achievement of objectives of an organization is set forth in these categories:

- Strategic
- Operations
- Reporting
- Compliance

In order to completely implement a comprehensive framework like this, one of the drawbacks faced is the investment of time and several resources significantly within an organization. Until the changed process reaches its potential, the framework implementation comes across as a very big challenge to the organizations.

VI. BENEFITS OF IMPLEMENTING THE COSO FRAMEWORK

The research by Brian Ballaou and Dan L. Heitger [9] identifies some benefits by the implementation of COSO ERM framework by using a building block approach.

- Size does not matter – COSO proclaims that the ERM framework is suitable for all types of organizations whether large, medium or small provided the presence of all components and its functioning.
- Culture shift takes time – Getting to bring in the change in employees' mindset about the incorporation of risk management practices will not happen over a small period of time. But as the employees watch the senior management adopting it, they are also likely to adapt to the changes soon.
- Better allocation of resources – By understanding the enterprise wide risks, the senior management can analyse and identify the requirement of resources for each component of ERM.

Shad, M. K., & Lai, F [10] in their research mention that the implementation of ERM benefits the organizations in terms of improved decision making, data collection, enables stronger corporate governance. Also it helps in reducing the risks associated with business activities and cost of capital.

VII. CONCLUSION

Small and Medium Enterprises are prone to more number of risks in comparison with the larger enterprises. This paper shows a literature background regarding the importance of SMEs in Indian economy and the challenges faced by them.

In today's world, Enterprise Risk Management is very much essential for any organization. There is no end to an ERM process. When carried out effectively, ERM benefits the organization by avoiding surprises. COSO helped in setting the stage for ERM when the ERM framework got published in 2004. The COSO framework maybe slightly lengthy but can be applied to all types of organizations. Also it recognizes the importance of applying it to smaller organizations and shows that it is beneficial to them. It is one of the frameworks of ERM which is widely accepted by the organizations to use. In spite of some of the limitations

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posed by this framework, it is established as a framework which can be used globally for various types of organizations.

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