

## **FINANCIAL RISK MANAGEMENT IN SMALL AND MEDIUM ENTERPRISES (SMES): A STUDY OF RETAIL AND SERVICE SECTORS**

<sup>1</sup>Prof. (Dr.) Vellayan Srinivasan, School of Management, S.A. College of Arts and Science,  
Orcid id: 0000-0002-4380-0185, [nivasvasan2000@gmail.com](mailto:nivasvasan2000@gmail.com)

<sup>2</sup>Dr. Viji R, Director - School of Management, S.A. College of Arts & Science,  
[Orcid ID: 0000-0003-0776-0830](https://orcid.org/0000-0003-0776-0830), [drvijiprof@gmail.com](mailto:drvijiprof@gmail.com)

### **Abstract**

Small and Medium Enterprises (SMEs) play a vital role in economic development, employment generation, and innovation. However, SMEs in retail and service sectors face significant financial risks such as liquidity constraints, credit risks, market volatility, and operational inefficiencies. This study investigates financial risk management practices among 100 SMEs (retail and services) and examines their impact on business sustainability and performance. Primary data were collected using structured questionnaires and analyzed using descriptive statistics and percentage analysis. The findings reveal that most SMEs lack formal risk management systems, rely heavily on personal judgment, and face challenges in accessing institutional credit. The study suggests strengthening financial planning, improving credit management, and adopting digital financial tools to enhance resilience and sustainability.

**Keywords:** Financial Risk Management, SMEs, Retail Sector, Service Sector, Liquidity Risk, Credit Risk, Sustainability

### **1. Introduction**

Small and Medium Enterprises (SMEs) are considered the backbone of many developing economies, including India. They contribute significantly to GDP, exports, and employment generation. Despite their importance, SMEs are highly vulnerable to financial risks due to limited capital, weak financial planning, and dependence on external financing.

Financial risk management refers to identifying, assessing, and controlling financial uncertainties that may impact business performance. In retail and service sectors, SMEs face risks related to cash flow instability, delayed customer payments, rising operational costs, and credit defaults.

This study focuses on understanding how SMEs in retail and service sectors manage financial risks and the challenges they face in ensuring financial stability.

## **2. Review of Literature**

Many researchers have explored financial risk management in SMEs:

- **Beaver (1966)** emphasized that financial distress prediction is critical for small firms due to higher vulnerability.
- **Altman (2000)** introduced models for bankruptcy prediction, widely used in SME financial analysis.
- **Fatoki (2014)** found that SMEs often fail due to poor credit management and lack of financial planning.
- **Berryman (1983)** highlighted cash flow problems as the major cause of SME failure.
- **OECD (2019)** reported that SMEs face higher borrowing costs and limited access to financial institutions.
- **Agyapong et al. (2016)** observed that risk management practices significantly improve SME performance in developing countries.

Financial risk management in Small and Medium Enterprises (SMEs) has been widely studied in recent decades due to the increasing recognition of SMEs as the backbone of global economies. However, despite their importance, SMEs remain highly vulnerable to financial instability due to limited access to capital, weak financial structures, and lack of formal risk management systems.

### **2.1 Foundational Theories of Financial Risk in SMEs**

The concept of financial risk management in SMEs is grounded in early financial distress prediction models. Beaver (1966) was among the first researchers to identify that financial ratios can be used to predict corporate failure through univariate analysis. This was further extended by Altman (1968), who developed the Z-score model using multiple discriminant analysis to assess bankruptcy risk. Altman's model introduced key financial dimensions such as liquidity, profitability, leverage, solvency, and activity ratios, which remain fundamental in SME risk assessment today.

Later studies such as Ohlson (1980) and Zmijewski (1984) refined bankruptcy prediction using logistic regression models, improving accuracy in financial distress forecasting. These models collectively highlight that SMEs are particularly sensitive to financial structure weaknesses, especially in liquidity and leverage management.

## **2.2 SME-Specific Financial Risk Characteristics**

Research shows that SMEs differ significantly from large firms in terms of financial risk exposure. Edmister (1972) was one of the earliest researchers to apply bankruptcy prediction specifically to SMEs, highlighting that traditional corporate models are less effective for small businesses due to limited financial disclosure and irregular financial patterns.

SMEs are more prone to liquidity risk, credit risk, and cash flow instability because they depend heavily on short-term financing and customer credit cycles. According to Berryman (1983), poor cash flow management is one of the primary causes of SME failure. Similarly, Fatoki (2014) found that inadequate credit control and weak financial planning significantly contribute to SME financial distress.

## **2.3 Liquidity and Credit Risk in SMEs**

Liquidity risk is consistently identified as the most critical financial risk in SMEs. Studies by Altman et al. (2010) show that SMEs rely heavily on external financing, making them vulnerable to interest rate fluctuations and credit tightening. Lack of internal reserves further increases exposure to liquidity shortages.

Credit risk is another major concern, as SMEs often extend credit to customers without strong risk assessment systems. According to Bruns and Fletcher (2008), banks perceive SMEs as high-risk borrowers due to asymmetric information and weak financial reporting systems. This increases borrowing costs and limits access to formal credit markets.

Recent literature also confirms that SMEs face higher default probabilities compared to large firms due to unstable revenue streams and weak collateral structures .

## **2.4 Risk Management Frameworks in SMEs**

Traditional Enterprise Risk Management (ERM) frameworks were initially designed for large corporations and are often not fully applicable to SMEs. COSO (2004) defines ERM as a

structured process for identifying and managing risks across an organization. However, SMEs often lack the resources and expertise to implement such comprehensive frameworks.

Henschel (2008) and Brustbauer (2014) argue that SMEs tend to adopt informal and reactive risk management practices rather than structured systems. This includes reliance on owner experience, intuition, and short-term financial planning instead of formal risk measurement tools.

A systematic review of SME risk management literature confirms that most SMEs have fragmented and inconsistent risk management practices, with limited integration into strategic decision-making processes.

## **2.5 Financial Risk Management Models and Analytical Tools**

Several models have been developed to assess financial risk in SMEs. Altman's Z-score remains one of the most widely used models, though it was originally designed for large manufacturing firms. Later adaptations improved its applicability to SMEs, incorporating non-financial variables and qualitative indicators (Altman et al., 2010).

Edmister (1972) emphasized the importance of SME-specific ratio analysis, highlighting that financial distress in SMEs is often driven by short-term operational inefficiencies rather than long-term structural weaknesses.

More recent studies also explore advanced statistical techniques such as logistic regression, DEA (Data Envelopment Analysis), and Bayesian models for improved SME risk prediction accuracy.

## **2.6 Operational and Market Risks in SMEs**

In addition to financial risks, SMEs face operational and market risks such as inflation, demand fluctuations, and supply chain disruptions. According to OECD (2019), SMEs are more exposed to macroeconomic volatility due to limited diversification and smaller financial buffers.

Studies also highlight that external shocks such as interest rate fluctuations and regulatory changes significantly increase SME vulnerability, particularly in developing economies where financial systems are less stable.

## **2.7 Risk Management Challenges in SMEs**

Despite increasing awareness of financial risks, SMEs face several challenges in implementing effective risk management systems:

- Limited financial literacy among owners
- Lack of formal accounting systems
- Dependence on short-term financing
- Weak access to banking and institutional credit
- Absence of dedicated risk management departments

Research indicates that SMEs often prioritize survival and cash flow management over long-term risk planning. As a result, risk management remains largely informal and reactive rather than strategic.

## **2.8 Summary of Literature Gap**

The literature clearly shows that while financial risk management frameworks are well-developed for large corporations, SMEs still lack customized, practical, and cost-effective models. Existing research emphasizes:

- Over-reliance on traditional models like Altman Z-score
- Limited SME-specific risk measurement frameworks
- Weak integration of financial and operational risk analysis
- Need for empirical studies in developing economies

Therefore, there is a strong need for sector-specific, empirically tested financial risk management models tailored for SMEs, particularly in retail and service sectors.

These studies indicate that financial risk management is essential for SME survival and growth, yet often underdeveloped in practice.

### 3. Objectives of the Study

1. To identify major financial risks faced by SMEs in retail and service sectors.
2. To analyze existing risk management practices adopted by SMEs.
3. To examine the relationship between risk management and business performance.
4. To suggest strategies for improving financial stability in SMEs.

### 4. Research Methodology

#### 4.1 Research Design

Descriptive research design is used.

#### 4.2 Sample Size

100 SMEs:

- Retail Sector: 50
- Service Sector: 50

#### 4.3 Data Collection

Primary data collected through structured questionnaires and interviews.

#### 4.4 Tools for Analysis

- Percentage analysis
- Descriptive statistics
- Comparative analysis between sectors

### 5. Data Analysis and Results

**Table 1: Major Financial Risks Faced by SMEs**

| Type of Risk     | Retail (%) | Service (%) |
|------------------|------------|-------------|
| Liquidity Risk   | 78         | 72          |
| Credit Risk      | 65         | 70          |
| Market Risk      | 60         | 55          |
| Operational Risk | 58         | 62          |
| Inflation Risk   | 70         | 68          |

**Interpretation:** Liquidity risk is the most significant issue in both sectors.

Table 2: Risk Management Practices Adopted

| Practice                 | Retail (%) | Service (%) |
|--------------------------|------------|-------------|
| Formal Risk Policy       | 35         | 30          |
| Cash Flow Monitoring     | 68         | 72          |
| Insurance Coverage       | 40         | 45          |
| Digital Accounting Tools | 55         | 60          |
| No Formal Strategy       | 25         | 28          |

**Interpretation:** Majority of SMEs rely on informal practices rather than structured risk management systems.

Table 3: Financial Performance Indicators

| Indicator              | Retail SMEs | Service SMEs |
|------------------------|-------------|--------------|
| Profit Stability       | Moderate    | Moderate     |
| Cash Flow Consistency  | Low         | Low          |
| Debt Repayment Ability | Moderate    | Moderate     |
| Business Growth Rate   | Moderate    | Moderate     |

## 6. Discussion

The findings indicate that SMEs in both retail and service sectors face similar financial challenges, particularly liquidity and credit risks. The absence of formal risk management frameworks exposes businesses to financial instability. However, SMEs that use digital tools and maintain cash flow monitoring systems show comparatively better financial performance.

## 7. Conclusion

The study concludes that financial risk management is still at a developing stage among SMEs in retail and service sectors. Most enterprises rely on informal judgment rather than structured systems. Strengthening financial literacy, adopting digital accounting tools, and improving access to credit facilities are essential for enhancing SME sustainability. Policymakers and financial institutions should support SMEs with training programs and easier financing options.

## 8. Recommendations

1. Implement formal financial risk management frameworks.
2. Adopt accounting and ERP software for better monitoring.
3. Improve credit assessment practices.
4. Increase financial literacy among SME owners.
5. Encourage insurance coverage for business risks.

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