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**Article**

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Journal of Risk and Financial Management

**Provided in Cooperation with:**

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*Suggested Citation:* Noraznira Abd Razak et al. (2023) : Capabilities and reputation risks towards firm performance, Journal of Risk and Financial Management, ISSN 1911-8074, MDPI, Basel, Vol. 16, Iss. 2, pp. 1-11,  
<https://doi.org/10.3390/jrfm16020125>

This Version is available at:

<https://hdl.handle.net/10419/275193>

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Article

# Capabilities and Reputation Risks Towards Firm Performance

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**Abstract:** The effects of firm-specific resources on firm performance has been a quest of many and widely studied worldwide. In today's business environment, arguments suggesting the relative importance of firm-specific resources in explaining firm performance variation are said to be of the greatest influence on the study of firm behavior. On the other hand, firms with strong, positive reputations can attract and retain crucial talent and often have loyal customers likely to buy a broader range of products and services. It can lead to higher sales generated by satisfied customers and their referrals and can potentially raise capital and share price, and improve the firm performance. An empirical study such as this attempts to investigate the combinations of resources of the firm and focus on reputational risk management concerning firm performance. As such, this study involves variables partially adopted from Donabedian Theory, such as intangible resources, namely capability as an exogenous construct towards endogenous construct and firm performance, as well as proposing a mediation model to analyze the mediated relationship of reputational risk in accelerating the relationship between capabilities and firm performance. This study applies variance-based structural equation modeling via Smart PLS to a sample of 161 listed firms in Malaysia as respondents. A judgment purposive sampling technique has been adopted as the respondents are derived from listed firms under Malaysian Bourse. Overall, the findings of this study reveal how firms may gain competitive advantages in terms of their reputation and eventually be able to sustain their firm's performances by implementing an integrative model of intangible resources such as capabilities and in their routines and processes within the firms.

**Keywords:** capabilities; reputation risk; firm performance; mediation model



**Citation:** Razak, Noraznira Abd, Najihah Hanisah Marmaya, Mohd Zailani Othman, Idris Osman, Suhailah Kassim, Fatin Aqilah Maskuri, and Nik Kutina Mat Tahir. 2023. Capabilities and Reputation Risks Towards Firm Performance. *Journal of Risk and Financial Management* 16: 125. <https://doi.org/10.3390/jrfm16020125>

Academic Editor: George Halkos

Received: 11 October 2022

Revised: 11 January 2023

Accepted: 12 January 2023

Published: 15 February 2023



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## 1. Introduction

It has been argued by Foss (1996, 1998) and Foss and Knudsen (2003) that capacities are among the most prominent dominant characteristics of the resources pool, which have the largest effect on business performance. It was also argued by Galbreath and Galvin (2008) that there is a substantial linkage between competencies and company performance. Erdil et al. (2010) claimed that their research showed a connection between fundamental personnel qualities, organizational capacities, and the success of a company.

Because Malaysia is working toward achieving sustainable economic development in which knowledge and know-how become the primary drivers of economic growth, it is particularly important to evaluate the significant aspect of know-how as a core skill among managers. This is because Malaysia is working toward achieving sustainable economic

development (Majlis Inovasi Negara 2007). On the other hand, Galbreath (2005) discovered that the misallocation of resources or the inability to fully employ the resources of the organization likewise had a substantial influence on the firm's performance. The possibility of suffering damage due to a damaging reputation event is, without a doubt, very real. This damage can manifest in various ways, including a decline in consumer confidence in the brand, an effect on revenue and earnings, and increased oversight from government officials. However, there is also the possibility to learn from how a reputation incident is handled, both to lessen the immediate impact of the event and to acquire long-term understanding that may be used to better respond to future situations. Therefore, an effective allocation of resources has to be established after giving careful attention to several factors, given the level of risk that is associated with a particular project or investment made by the company itself (Razak et al. 2016). In general, enterprise risk cannot be considered in a silo approach since the management of risks has several specialized hazards, including reputation risks. These risks fall under the umbrella of enterprise risk (Bhanot 2011; Heidinger and Gatzert 2018; Kim et al. 2021; Pretty 2018; Voskovskaya et al. 2022; Razak et al. 2016).

A stronger reputation and higher status are associated with greater access to essential resources and better organizational performance, according to the findings of a variety of studies that were conducted in the past (Kim et al. 2021). Furthermore, reputation is important to corporate practice since it is a valuable intangible asset that may contribute to a competitive advantage; hence, this research gives the necessary viewpoints (Veh et al. 2018).

There has been a lot of research done on how firm resources might affect a company's success. However, research studying the combinations of business resources and management of enterprise risks, particularly reputation risk, as they relate to firm performance, is scarce and currently barely scratches the surface (Razak et al. 2013). The proliferation of the internet and social media has led to an increase in the significance of reputation risk for businesses (Scott and Walsham 2005; Magnus Boyd n.d.; Walsh et al. 2016; Szyntar and Heijmeskamp 2020). In this environment, unwelcome news can particularly spread more quickly. One of the most important questions that must be answered by businesses is whether or not the state of their corporate reputation or the occurrence of reputation-harming events (also known as "crisis events") affects the financial performance of the company (Gatzert 2015).

The following portion will present a short review of the direct relation of capabilities to firm performance, as well as the roles of reputation risk as a mediating impact between the two variables.

## 2. Literature Review

### 2.1. Firm Performance

Previous research has shown that different articulations may be found across fields of study regarding the definition of performance. As a result, the notion of performance assessment inside academic borders changes distinctly (Venkatraman and Ramanujam 1986). Previous research on company performance may be broken down into three main groups. To begin, some studies outline the measurements utilized in entrepreneurship and strategic management research, such as (Brush and Vanderwerf 1992; Murphy et al. 1996; Carton 2005; Carton and Hofer 2010). Studies that focus on the need for multidimensional measures of organizational financial performance, such as (Rawley and Lipson 1985), (Jantunen 2005) and (Venkatraman and Ramanujam 1987), and finally, studies that seek to determine the "best" measures of organizational financial performance, such as (Robinson and Mcdougall 2001). Venkatraman and Ramanujam (1986) were certain that the success of a company should be evaluated using a wider range of metrics, including financial and operational considerations. Because of its connection to accounting measurements and the economy's success, financial performance analysis indicators such as the growth of sales, earnings per share, and profitability.

Nevertheless, operational success or performance not based on financial metrics still considers product quality, market share, and marketing efficiency. In addition, the

use of numerous performance indicators in empirical research was stressed by several academics, including (Demirbag et al. 2006). Previous empirical research also showed that the performance construct may be broken down into a number of different aspects (Venkatraman and Ramanujam 1986). However, no ultimate consensus has been presented in previous research on entrepreneurship and strategic management on the best or even a sufficient set of organizational performance measurements because there has been no research done on these topics. The vast majority of theorists have concluded that the nature of organizational performance is multidimensional (Carton and Hofer 2010). Accordingly, to ensure firm performance is measured accurately, Dess and Davis (1984) recommend that firms employ a composite measure by utilizing multiple indicators as it is more informative than relying on a single indicator only. Prior empirical research has demonstrated multiple dimensions of the performance construct (Venkatraman and Ramanujam 1986).

Venkatraman and Ramanujam (1987) empirically demonstrated that growth and profitability were different performance measures. Overall performance was measured with three perceptual items, including sales turnover and profitability as financial performance and market share as indicators of operating performance (Spanos and Lioukas 2001; Venkatraman and Ramanujam 1987). Venkatraman and Ramanujam (1986) also emphasized that business performance can always be measured by financial performance or operational performance, or even both, as the sources of performance data can either be primary (e.g., questionnaire survey) or secondary (e.g., published data). As such, this study follows the approaches of Venkatraman and Ramanujam (1986), Spanos and Lioukas (2001), and Galbreath and Galvin (2008) concerning the dimension of performance construct.

## 2.2. Capabilities

The idea of something being intangible refers to it being either imperceptible or unquantifiable. In contrast to physical resources, intangible resources are considerably harder to quantify due to the very nature of the resources themselves (Blair and Wallman 2001). According to Galbreath and Galvin (2008), intangible resources consist of many components not typically accounted for in the balance sheet. Intangible resources are described as “nonphysical factors that contribute to or are used in producing goods or providing services, or that are expected to generate future productive benefits for the individuals or firms that control the use of those factors,” according to the definition provided by (Blair and Wallman 2001).

The conceptual definitions in the literature (Hall 1992, 2002; Fahy and Smithee 1999; Hoopes et al. 2003; Ray et al. 2004) cover a wide range of topics, so it is difficult to say definitively whether some intangible resources are, in fact, assets or capabilities. However, there appears to be a fine line between the two. On the other hand, the technique proposed by Hall (1992, 2002) is used, which stipulates that intangible resources be classified as either assets (what the company has) or skills (what the firm does). The categories of resources that will be discussed and utilized in this investigation were decided upon because they have been referenced in a wide variety of previous research, such as the general management, strategic management, marketing, and economics literature, and because they are of interest to a large number of academics. The know-how and knowledge capacity of the company are reflected in its capabilities (Grant 1996; Galbreath 2005; Galbreath and Galvin 2008).

According to Amlt and Schoemaker (1993), the term “capabilities” refers to a company’s ability to deploy resources, often in combination, via organizational procedures, to achieve a certain goal. They are information-based processes that might be physical or intangible, are unique to the company, and are formed through time via the intricate interactions of its resources. In contrast to the other aspects of a company’s resources, capabilities are predicated on the firm’s human capital being able to create information, convey information, and exchange information with other people. According to Fahy and Smithee (1999), capabilities have been referred to using several names, such as talents, invisible assets, and intermediate products. They are also referred to as what an organization “does” as opposed to what it “has”, and they often include the routines and interactions that take

place inside the organization. Another way of describing them is as “what an organization “has”. A company’s capabilities include both the individual skills of its workers and the resources that emerge from the various interactions and routines that take place within the company itself. These interactions and routines can occur anywhere within the company, such as within teams, between workers and managers, or between personnel and tangible assets. They are distinguished by the presence of major obstacles to duplication, which may take the form of the tacitness inherent in the capabilities of people or groups or the intricacy and distinctiveness of organizational procedures.

These organizational capacities develop in tandem with organizational knowledge cycles, which begin with peripheral inducements and are then integrated via networking cycles to produce acquired knowledge inside the organization (Collis 1994; Collis and Montgomery 1995; Collis and Montgomery 1998). Before being used to address possible issues, this information is first made apparent and then transforms as it passes through several stages of internal selection, appraisal, and legitimization. In other words, the information is used and kept inside an organization by being ingrained in procedures and put into practice to generate retained knowledge via the accumulation of relevant experience (Collis 1994; Collis and Montgomery 1998). According to the theory put forward by HassabElnaby et al. (2012), organizational capabilities are a business’s capacities to carry out a set of activities using the resources available to the company. Companies cultivate and manage their organizational capabilities to acquire a competitive advantage by fostering organization-categorical competencies. This process is known as organizational capability development and management. The longer talents are used, the more robust they grow and the more difficult it is for rivals to copy them. The capabilities of an organization are significant organizational resources that help a company develop a competitive edge. It is necessary to create and maintain these talents dependent on the strategies and information systems of the companies for the company to gain long-term benefits in terms of its competitive position.

It is possible to consider capabilities to be the aggregate set of organizational skills or competencies the corporation possesses. Capabilities are complex phenomena that emerge as a direct consequence of organizational learning. Capabilities are never tangible (Prahalad and Hamel 1990). In many management and organizational studies, a variety of terms are used for capabilities, such as management process, roles, and skills. This is done in order to include all of these managerial requirements to reconfigure and transform organizations along with their resources and capabilities. The approach relates variation in management competencies to differences in business performance under situations of strategic change in an explicit manner (Helfat and Martin 2015). Therefore, skills are understood to be the capacity to organize and use resources in order to accomplish the objectives of the company. This suggests that disparities in performance are seldom brought about by differences in resources alone; rather, it is the use of resources that brings about differences in performance. Companies can better manage their operations and make better use of their resources when they have capabilities. Capabilities are characterized as complicated bundles of skills and accumulated knowledge (Day 1994).

The items that made up capabilities comprised the know-how of the firm’s managers, the know-how of workers who were not in management positions, and the collective know-how in constructing and preserving partnerships with external parties. Castanias and Helfat (2001) provided more evidence for similar ideas, namely that the success of a company is substantially tied to the abilities, competence, and knowledge of its managers. The individual talents of a company’s workers, in addition to the resources resulting from the myriad of transactions and routines that occur inside an organization, are referred to as the company’s capabilities (Fahy 2002). According to Amlt and Schoemaker (1993), capabilities are defined as the ability of a company to deploy resources, often in combination, via organizational processes, to achieve a desired purpose. Those organizational procedures inside the company itself, which include the practice of managing reputational risk (Razak et al. 2016). Mauri and Michaels (1998) and the most current study on the topic, conducted

by Galbreath and Galvin (2008), both hypothesized that their results demonstrated the primacy of firm effects, particularly the impact of capacity on firm performance.

### 2.3. Reputation Risk

According to Smith (2008), in general, a company's reputation is based on how stakeholders and people who are not affiliated with the company view the company's overall quality in terms of how it interacts with customers, employees, and vendors as well as how it manages its finances and fulfills its social responsibilities. It is very uncommon, and difficult to replicate, and there are no suitable alternatives, all of which contribute to the item's status as a strategic component of the company. As a result, a favorable association will be formed between it and the future success of the company. The existence of a cross-sectional link between reputation and financial success may be rationalized by many different possible advantages that come with having a good reputation (Roberts and Dowling 2002). Customers place a high value on affiliations and transactions with businesses that have a good reputation because of this. Reputation is prized for its own sake. When there is confusion over the fundamental quality of a company's products or services, reputation becomes crucial. It is difficult for competitive companies to swiftly produce quality demonstrations that would counteract the signaling advantages associated with having a strong reputation because of the same uncertainty.

Given the proliferation of social media and the rise of cybersecurity inside Industry 4.0, maintaining a positive corporate image is becoming ever more crucial. An emerging aspect of research is reputation risk, which keeps on expanding as more researchers and practitioners all over the world start to practice reputation risk holistically. This is due to the evolving nature of the risks, which correlates with the volatile and advanced tools of technology that relate to online and social media platforms in various business environments. Reputation risk research is growing as a result (Ben-Amar et al. 2014). Because of this, reputation risk is becoming an increasingly important problem in modern times since the success of a company is often dependent on its reputation (Boyd et al. 2010; Szyntar and Heijmeskamp 2020; Kunitsyna et al. 2018; Eckert 2017; Spanier 2015; Guo et al. 2020; Roberts and Dowling 2002; Etter et al. 2019). Accordingly, Peterson (2006) defines reputation risk as arising from a situation, occurrence, business practice, or event that tends to materially influence the perceived trust and confidence of the public or stakeholders in an institution. Reputation risk can be caused by a situation, occurrence, business practice, or event.

According to Stephen P. D'Arcy (2001), developments in technology, the quickening pace of business, globalization, rising levels of financial sophistication, and the unpredictability of the global economic environment all contribute to an increase in the overall number of risks as well as their level of complexity in today's world. This is especially true regarding the risk that pertains to the reputation of companies. According to Beasley et al. (2005), there is a favorable association between the knowledge and abilities of senior management team members, such as the chief risk officer, and the implementation and efficacy of a variety of risks, including reputation risk. By creating online communities that facilitate connection and interaction between users, national social media platforms such as Facebook, YouTube, Twitter, LinkedIn, and Instagram, among others, continue to draw billions of users. These web-enabled platforms provide novel opportunities for socialization and interaction among users, thereby transforming how individuals and groups share information such as personal data, news, opinions, and feedback regardless of whether the respective businesses are based solely or simply on the enhancement of the promotion of products and services, or the firm depends on its performance of online businesses (Raina and Rana 2019).

Both Barakat et al. (2018, 2019) stressed in their research that risk appetite, incorporated within the reputation risk factor, also indirectly boosted organizational performance (e.g., improved returns, profits, and growth). Because Hoyt et al. (2008) found a positive association between the practice of reputation risk and company performance, they stressed that there is an influence on firm performance of up to 17% due to the practice of reputation

risk. The finding is also consistent with the findings of [Liebenberg and Hoyt \(2003\)](#) and [Kleffner et al. \(2003\)](#), who also emphasized the skills of senior management, such as the chief risk officer as risk champion, that can lead the firm toward the effectiveness of the reputation risk as part of specific risks that existed within the firm. The finding was made by [Kleffner et al.](#) and [Liebenberg](#).

As a result, the following hypothesis has been proposed as a result of this research:  
Thus, this research proposes the following hypothesis:

**H1.** *Capabilities have a positive relationship with firm performance;*

**H2.** *Capabilities have a positive relationship with reputation risk;*

**H3.** *Reputation risk has a positive relationship with firm performance.*

Great economic damage was caused as a result of the global financial crisis that occurred between 2008 and 2009. This demonstrates that the linkage of the relationship between capabilities and firm performance can be strengthened by effectively managing the various risks that the firm faces, even though this requires strict monitoring from regulators ([Mikes and Kaplan 2013](#)). Regardless, the preceding studies contribute to the growing theoretical void this study seeks to fill. Namely, reputation risk has never been regarded as a mediating variable between skills and the relationship between them and business performance.

**H4.** *The relationship between capabilities and firm performance will be mediated by the effectiveness of reputation risk.*

### 3. Methodology

This research applied a self-administered questionnaire to collect the data. Measurement of the variables adopted from [Galbreath and Galvin \(2008\)](#) involving 27 items in total. This research adopts the methodology of ([Ghazali and Manab 2013](#)), which used the same data sources from Bursa Malaysia but did not include PN17 or GN3 firms in its analysis. The PLS-SEM was used in this study to do data analysis. As the population size was derived at 928, the sample size for this study was determined through the sample size table established by [Sekaran \(2013\)](#), which is at 250. To achieve an adequate response rate, a total of 650 questionnaires were distributed. There were a total of 161 replies considered to be legitimate after the questionnaire was sent to 650 people. Out of a total of 928 firms that were listed in Malaysia, adequately, 24.7 percent responded to the survey.

### 4. Results and Discussion

As the companies were from a wide range of industry groups, variation in the samples shows the overall industries represented the population of publicly listed companies under Bursa Malaysia. The distribution showed that slightly more than half of the sample (55.6%) was from large-scale companies (more than 500 employees). As far as the length of operation is concerned, 8 percent of the companies have been in operation for more than 10 years. The demographic data of the respondents showed that they all come from diverse educational backgrounds. More than 72 percent of the respondents have more than 10 years of working experience, indicating they have many experiences in their respective departments of corporate affairs and communications and are capable and reliable of answering the survey questionnaire without bias which is important for the validity of this study.

#### 4.1. Assessment of Reflected Measurement Model

All item loadings were greater than 0.50 and significant at the 0.01 level, indicating convergent validity at the indicator level ([Hulland 1999](#)). All average variance extracted (AVE) values were greater than 0.50, suggesting convergent validity at the construct level. A measurement model is considered to have satisfactory internal consistency reliability when the

composite reliability (CR) of each construct exceeds the threshold value of 0.7 (Gefen et al. 2000). A CR number of more than 0.70 indicates the dependability is satisfactory.

Thus, the results indicate that the items used to represent the constructs have satisfactory internal consistency reliability. The results stated above are as follows in Table 1:

**Table 1.** AVE and Composite Reliability.

Latent Variable	Cronbach’s Alpha	Composite Reliability	Average Variance Extracted
CAPABILITIES	0.814	0.867	0.525
REPUTATIONAL RISK	0.972	0.974	0.641

Based on Table 2, off-diagonal elements are lower than the square roots of AVE (bold on the diagonal). Hence, the result indicates an adequate discriminant validity for all the reflective constructs.

**Table 2.** Fornell-Larcker Criterion.

Latent Variable	Capabilities	
CAPABILITIES	<b>0.718</b>	
	0.303	<b>0.817</b>

As for Table 3, the HTMT criterion also indicates that the confidence interval does not show the value of 1 on any of the constructs, confirming discriminant validity.

**Table 3.** Heterotrait-Monotrait Ratio (HTMT).

Latent Variable	Capabilities	Reputational Risk
CAPABILITIES		
REPUTATIONAL RISK	0.560	

#### 4.2. Assessment of Structural Model

Henseler et al. (2009) indicate that moderate or average R2 values are acceptable when the endogenous construct is explained by a few exogenous constructs. For this research, capabilities explained 9.2% of the variance with R2 = (0.092), considered moderate, and reputation risk (able to explain 53% of the variance in firm performance. The f2 value of 0.10 indicates capabilities have a small effect in producing the R2 for reputation risk. On the other hand, the f2 value of 0.65 indicates a large effect in producing the R2 for firm performance. The predictive relevance (Q2) has a value of greater than 0, which indicates that the model has a medium predictive relevance for the performance construct.

Results from the study indicate that capabilities are one of the significant predictors in explaining the relationships of resources towards the firm’s performance. This supports the finding of Galbreath and Galvin (2008) concerning the significant impact of capabilities on any positive outcome for the organization. As such, H1 was supported. As shown in Table 4, the hypotheses relating capabilities to the reputation risk were unsupported as the structural path coefficient was in the negative range. Therefore, H2 was rejected. As for H3, the finding shows that reputation risk provides a significant impact on firm performance.

**Table 4.** Path coefficients, Observed t-statistics, and results for all hypothesized paths.

Hypothesis	Path Coefficient	t-Value
Capabilities -> Firm Performance	0.303	4.455 **
Capabilities -> Reputation Risk	−0.023	0.376
Reputation Risk -> Firm Performance	0.735	19.929 **

Note: \*\* t-values > 2.33 (p < 0.01) (one-tailed test).



Based on Table 5, as indicated by Preacher and Hayes (2008), the significant indirect effects 95% Boot CI: [LL = 0.123, UL = 0.319] did not straddle a 0 in between, indicating mediation. Thus, this testing concluded that reputation risk had a significant mediation effect between capabilities and firm performance relationships.

**Table 5.** Bootstrapped confidence interval calculation.

Indirect Effect	SE	t-Values	LL	UL
0.221	0.050	4.421 **	0.123	0.319

Note: \*\* t-values > 2.33 ( $p < 0.01$ ) (one-tailed test).

### 5. The Final Thoughts

According to the findings of this research, the connection between capabilities and performance is favorably mediated by reputation risk as an element of particular holistic hazards within the context of the risk management framework of the company. According to the findings of the study, publicly traded companies in Malaysia need to pay more attention to the efficient allocation of intangible resources, such as capabilities, to guarantee that managing those elements, which undoubtedly exist in the company regardless of whether or not the company’s employees like it, has been realized. This result is also supported by a number of previous studies, such as Galbreath and Galvin (2008), both of which indicate that human capital, specifically capabilities, which are part of the intangible resources domain, exerts a direct and indirect influence on firm performance through various factors such as business processes, etc. Therefore, investment and growth in conjunction with a robust domain of resources like capabilities are proposed in order to accomplish the goals of achieving steady and improved performance by the organization.

The findings of this research indicate that the hypothesis of a positive link between capabilities and reputation risk toward firm performance is confirmed. This is shown by the fact that the hypothesis was shown to be supported by the findings. On the other hand, there is no evidence to suggest that capabilities and reputation risk are positively correlated. The results demonstrated that capabilities, a kind of intangible element of the company, are embedded along with reputational assets, a type of domain inside the company’s intangible resources (Galbreath and Galvin 2008).

As a result of this, there is a risk that redundant testing of the same piece may take place. The reputation of a company is considered to be the firm’s asset within the wide category of intangible resources, and it coexists with the capabilities, which are also a part of the larger picture of intangible resources, and it is intimately connected with those skills (Razak et al. 2016). Previous empirical research contradicts the findings of this study by demonstrating a positive and substantial correlation between intangible resources and enterprise risk in a unidimensional way (including reputation risk). This link was shown to exist between the two variables (e.g., Wan Daud et al. 2011; Kimbrough and Componation 2009; Wanlapa and Saenchaiyathon 2014). Liu (2011) provided evidence that supported the hypothesis that a positive correlation exists between organizational culture and knowledge management and business risk, namely reputation risk, among other risks. According to Kimbrough and Componation (2009), it is realistic to predict that an organization’s internal culture will play a substantial role in ERM deployment success. The research conducted by Kimbrough and Componation (2009) demonstrates that deploying ERM should demonstrate the desired cultural characteristics. These characteristics include cross-functional cooperation, open communication across a network, and trust in associates’ competency and willingness to deal with risks that can affect the entire organization. Involving and testing these three constructs in a mediating manner shall bear positive results. It can lead to fruition steps initiated by the firm to ensure that the priority of specialized risks, such as reputation risk, has been closely monitored and scrutinized, and has been adopted continuously to ensure the firm’s continued viability in the years to come. This study suggests an addition of various resources dimension be added in future research, as well as considering improving government policy concerning the implementation of a risks framework that relates to

small to medium enterprises. It has limitless variation of dimension involves especially when the nature of companies are uniquely differs.

**Author Contributions:** Conceptualization, N.A.R. and M.Z.O.; methodology, N.A.R. and N.H.M.; software N.A.R., I.O.; validation, N.A.R., S.K. and N.H.M.; formal analysis, N.A.R. and M.Z.O.; investigation, F.A.M. and N.K.M.T.; resources, M.Z.O. and I.O., S.K.; data curation, N.A.R., N.H.M.; writing—original draft preparation, N.A.R.; writing—review and editing, N.A.R. and F.A.M.; visualization, S.K., I.O.; supervision, N.A.R.; project administration, M.Z.O.; funding acquisition, N.A.R., M.Z.O., S.K. All authors have read and agreed to the published version of the manuscript.

**Funding:** Fundamental Research Grant Scheme: FRGS/1/2021/SS01/UITM/02/9 by Ministry of Higher Education (MOHE) with RMC File No. 600-RMC/FRGS 5/3 (050/2021).

**Data Availability Statement:** Not applicable.

**Conflicts of Interest:** The authors declare no conflict of interest.

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