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**Article**

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# Characteristics and Categories of Risk in the Small Enterprises

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## Summary

*In this article risk typology in a small enterprise has been presented. In the aspect of a small enterprise's characteristic features that have been synthetically described, the author has tried to define the crux and position of individual risk types in the operation of small market entities. In economy practice, identification and risk management conduct of risk categorization facilitates.*

## Introduction

Every entrepreneur who starts their own business instantly undertakes risk, even if he or she is not fully aware of that. Risk of conducting business activity results from the environment in which an enterprise operates and from processes inside the enterprise as well. Lack of risk awareness can have serious consequences that eventually can lead to the enterprise's insolvency and bankruptcy. Classification of risk in a small enterprise is the kind of formalization the process of risk identification. Mistakes in risk management, made by an owner of a small enterprise do not result from use of inefficient instruments or financial tools. Majority of losses caused by risk (here it is a negative aberration from assumptions) in an enterprise result from lack of risk identification during the initial phase. It is, therefore, latent risk and comes to light only when its negative results cannot be undone (Borkowski, 2008: 77).

The aim of this article is to categorize the risk. In the light of characteristic features synthetically presented for small enterprises, the author will try to define the nature and the place of specific types of risk in business activity of these market entities.

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## 1. Characteristics of small enterprises

In theory and practice, distinction of enterprises is done on the basis of both quantitative and qualitative criteria. In the former: size of employment, value of possessions, i.e. assets and value of turnover are taken into consideration first of all (Skowronek-Mielczarek, 2007: 2). A leading criterion is the number of people employed in an enterprise. For small enterprises the upper limit is 50 employers. This threshold in a quantitative criterion is common especially in the European Union.

Distinction of small enterprises can be also conducted on the basis of qualitative features with the assumption that there is a certain set of features that characterize only this group of enterprises. It includes functions, areas and methods of operation and patterns of behavior that are not present in medium and large enterprises or are realized in these enterprises in a very different way. Typical identifiers that distinguish small enterprises with regard to qualitative features can be put in the following catalog (Mugler, 1998: 18 – 23):

- enterprise is dominated by entrepreneur's personality,
- enterprise has a network of personal contacts with customers, suppliers and is relatively open towards them,
- enterprise provides services according to customers' individual needs,
- contacts between entrepreneur – manager and workers are tight and direct,
- enterprise's organization is very little formalized,
- management can react quickly to changes in the surroundings,
- enterprise has little share in the market,
- there is a clear dependence between efficiency and quality of the employed,
- enterprise has little possibility to get highly-qualified workers (Kaczmarek, 2008: 291);
- entrepreneurs are economically and legally independent;
- enterprise's activity is often connected with one product or is weakly diversified;
- there is a separate type of financial economy (Łuczka, 2001: 16);

Risk categorization will be presented in the light of features that characterize a small enterprise. This improves its identification and evaluation in economic practice.

## 2. Risk categories in a small enterprise

For an owner of a small enterprise, risk informs about lack of theoretical and practical tools to recognize all parameters that specify conditions in which an enterprise can function. Generally, risk in an enterprise includes all its functions and branches of activity, starting with technical and finishing with management-related ones. Trying to categorize risk, we should take into consideration that categorization is very flexible. Every classification is a tool to make identification of threats more efficient in an enterprise. This superior aim should be taken into account when identification is used.

Risk in small enterprises can be divided into two basic groups. The first includes specific risk types that result from small enterprises operating as commercial

organizations, while the other one groups the risk that is connected with the enterprises' operations in widely understood environment. The main risk categories that can be found in small enterprises are presented in Table 1.

**Table 1.** Main risk categories in small enterprises

| RISK CATEGORY   | MAIN CAUSES / AREAS OF INFLUENCE   |
|---|--|
| <b>RISK CATEGORIES CONNECTED WITH OPERATION OF AN ENTERPRISE AS A COMMERCIAL ORGANIZATION</b>   |  |
| Personal of the owner   | Death (illness) usually leads to an enterprise's decline. In case of business activity conducted by a natural person, owner's death excludes the possibility to continue functioning.<br>Loss of / drop in owner's and family members' incomes.  |
| Embezzlement (fraud) of workers   | Mistakes made by workers, deliberate, unfavorable for the enterprise, actions, risk of taking over the idea for business activity and customers.   |
| Financial:<br>A. Credit (transactional)<br>B. Liquidity   | A. Failure to fulfill obligations by a commercial partner, threat of trust abuse, misuse of non-market relations,<br>B. Problems with maintenance of own short- and long-term financial liquidity.   |
| Strokes of fate   | Accidents (fire, explosion, theft, devastation, failure of machines and appliances, etc.).   |
| Innovation (development)  | Research effectiveness and possibilities to use its results in the enterprise's activity.  |
| Product (services)  | Quality and features of products (services).   |
| Accounting  | Accounting figures do not correlate with the actual property's worth as a consequence of purposeful mistakes and actions.  |
| Loss of reputation  | Loss of reliability and problems with image, no possibility to develop and addiction to wrong tendencies in the market.  |
| <b>RISK CATEGORIES CONNECTED WITH OPERATION OF AN ENTERPRISE IN THE MARKET</b>  |  |
| Force majeure – nature  | Natural disasters (floods, tornadoes, droughts, storms, gales, etc.).  |
| Market:<br>A. Variable prices of raw materials,<br>B. Variable prices of articles, products or services,<br>C. Competition<br>D. Monetary,<br>E. Interest rates,<br>F. Prices of financial instruments. | A. Fluctuations of raw materials' cost,<br>B. –Fluctuations of sales income,<br>C. Actions undertaken by enterprises that offer substitutes.<br>D. Variable exchange rates,<br>E. Variable interest rates,<br>F. Fluctuations of basic and derivative prices of financial instruments (insurance, factoring, letters of credit, options, contracts with fixed time limit, etc.). |
| Legal   | Contracts' defectiveness, trials in court, legal ignorance   |
| Political (including country risk)  | Political decisions in the country in which the enterprise is registered or in other countries where the enterprise conducts its business activity. Convertibility and access to the country's currency.   |
| Business cycle  | Change of business conditions due to recession or crisis (Keller2002: 26 – 31).  |
| Civil liability of entrepreneur in relation to the public   | Unlawful acts.   |
| Ecological  | Threats to natural environment as a consequence of the enterprise's actions.   |

Source: own study.

The classification presented is general because every phenomenon that changes an enterprise's value can be considered risky in a small enterprise. To a manager whose task is to identify risk in an enterprise, types of risk that can be managed actively are important.

Domination of an entrepreneur's personality in a small enterprise makes the personal risk of the owner most important with regard to the activity he/she conducts. Personal risk can be defined as the possibility for negative economic results (income loss, extraordinary expenses, decrease of assets) resulting from occurrence of some (negative) events (seen as danger) in life, health or a person's ability to work (Kania, 2008: 18).

Important in this typology is the risk of fraud and embezzlement of workers. This type of risk results most of all from informal nature of contacts between the owner and workers. It can cause a lot of threats connected with disloyalty of workers who know many advantages and disadvantages of the enterprise in which they work. It additionally causes possibility of risk from workers who, after gaining experience, will try to run a competing enterprise on their own. They have access, due to small magnitude of activity, to majority of the enterprise's information resources that are an important tool in making the decision to start up and conduct business activity.

Another type of risk connected with a small enterprise's activity is in commercial contacts of the owner with other market entities – known as transactional risk. It mostly concerns customers and suppliers with whom cooperation is often informal. Owners of small enterprises often see commercial contracts and cooperation with commercial partners too optimistically. Conducting this cooperation in an informal way can only lead to more obstacles with recovery of receivables that are due.

Next, risk connected with strokes of fate that cause losses in the property possessed should be discussed. Although small enterprises do not usually own much assets, such strokes of fate as fire, theft, failure of machines or appliances can seriously hinder conducting current service, commercial or production activity. The consequence of a specific type of risk coming true (stroke of fate) is often inability to continue activity for some time and, in this way, to generate incomes.

In risk typology, there are also types of risk connected with innovativeness of small enterprises (Okoń-Horodyńska, Zachorowska-Mazurkiewicz ed., 2008). High risk level is a characteristic feature of innovation process where decisions are seldom made with complete certainty possible when all the information has been gathered and potential results have been fully anticipated (Świdorska, 2008: 33). Apart from risk that accompanies the majority of innovation processes, an enterprise that conducts innovative activity as well as research, is also prone to risk that is specific to that kind of activity.

The next risk, product risk, is connected with the specifics of the market offer of the enterprise. It depends on fashion trends and customers' habits. Product risk can be explained by means of the products' life cycle theory, which is an important element of the concept and practical use of marketing.

In the process of risk management, accounting risk and loss of goodwill risk should be taken into consideration. The former is connected with discrepancy between the property's actual value and its book value. Goodwill and the related risk depends most of all on the enterprise's quality of service. Goodwill generates customers' loyalty and workers' creative involvement. It is a distinctive ability of an enterprises and the most

important commercial tool to inform customers. Goodwill is related with product features, company name, brand and trademark, and the value of goodwill is simply the probability that product will be purchased again.

Risk that is present in the activities of small enterprises is also connected with the enterprise's functioning in widely understood market environment. In this risk category we can list: risk that results from natural events, market risk, legal risk, political risk, risk that results from the enterprise's civil liability to others, risk that depends on prosperous economy and subcategory of lesser importance: ecological risk.

Natural risk is the one that nature generates and that is connected with destructive influence of natural forces. The risk results from insufficient cognition of the forces and possibility to control them by human beings, with continuous increasing use of these forces in the economy. The causes of natural risk are most of all various climatic changes as a consequence of environmental pollution due to intensive development of industry.

The next risk category in an enterprise is market risk. In this group, from the perspective of a small enterprise, we can distinguish most of all: risk of variable prices of raw materials, variable prices of products or services, competition, variable currency prices, exchange rates or variable prices of financial instruments. Generally, market risk is connected with operating in the market, where prices may change. This risk can cause losses due to changeable market situation: changing prices of assets and market parameters (rates of exchange and interest rates). Currency risk mentioned in this category refers not only to small enterprises that operate in international markets. This risk category is also connected with financial policy of enterprises that finance their activity by taking loans in foreign currencies. Rate of exchange risk is connected with actual threat for an enterprise with regard to foreign transactions planned by the enterprise in the future. The risk means loss of expected value of cash flows (decrease of future incomes and increase of costs) (Najlepszy, 2000: 119).

The next, legal risk can be defined as probability to incur material and non-material losses that arise, among other reasons, as a consequence of wrong or too late development or passing of legal regulations, changes in jurisprudence, wrong shape of legal relations or unfavorable decisions of courts or public administration organs that settle disputes which arise in connection with legal relations of a given organization with other entities (Zapadka, 2007: 14).

Political risk appears as a consequence of political actions and decisions taken on a state level in a given country. Symptoms of political risk can be both social events such as war, military coup, riots, strikes, terrorist attacks, but also administrative decisions, legal regulations, nationalization, cancellation of an import license. Political risk is connected with threat from a foreign country's government with regard to violation or breach of promises or agreements after an investment has been made. Factors that influence political risk of a country and affect it deeply are the following (Bielawska, 2003: 251): political management, internal order, social relations and legal order.

Risk that results from civil liability of an enterprise should also be explained. Within the framework of Polish law, this type of risk can be considered according to the, so called, liability regime, where there are: risk of liability in tort due to unlawful deed (*ex delicto* – art. 415 c.c.) and contractual liability due to failure to perform obligations or due to

misperformance of obligations (*ex contract* – art. 471 c.c.). Three premises must be present so that an obligation to repair damage connected with tortious liability can arise (Monkiewicz, 2002: 314 – 315): occurrence of damage (financial or/and non-financial), the fact that the damage must be caused by some event (human action or another incident) and the condition that there is a causal relation between the damage and the event. Liability rules are also at work here (Kowalewski, 2006: 365): rule of fault (Art. 415 of the Civil Code), rule of risk (Art. 436 of the Civil Code) and rule of rightness (Art. 428 of the Civil Code). In contractual regime, there are also three premises of liability in tort that are necessary for a debtor's liability for damages to appear (Monkiewicz, 2002: 314 – 315): a creditor must suffer damage understood as financial loss, the damage must be caused by non-performance or misperformance of obligations by a debtor, there must be a causal relation between non-performance or misperformance of obligations and the damage. Contractual liability for the damage is based on the two rules: of fault and of risk.

## Conclusions

The basic risk types related with a small enterprise's activity that have been discussed are the foundation in the process of risk management. However, it should be taken into consideration that every enterprise has its own activity profile, hence it is often necessary to extend a given suggested risk category, depending on the purpose for which the risk classification is created.

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## **Specyfika i kategorie ryzyka w małych przedsiębiorstwach**

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### **Streszczenie**

*W artykule przedstawiono typologię ryzyka działalności małego przedsiębiorstwa. Przedstawiono w syntetyczny sposób cechy charakterystyczne małego przedsiębiorstwa oraz podjęto próbę określenia istoty i pozycji poszczególnych rodzajów ryzyka w funkcjonowaniu małych podmiotów rynkowych. Przeprowadzenie w praktyce gospodarczej kategoryzacji ryzyka ułatwia identyfikację i zarządzanie nim.*