RISK MANAGEMENT PRACTICES AND THE PURCHASE OF INSURANCE BY SMES

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Abstract

The culture of risk aversion constrains the growth of the Small and Medium Enterprises (SME) sector among low-income entrepreneurs. They respond reactively to risk by using risk avoidance or by transferring the risk. The purpose of this study was to establish whether SMEs mitigate risk through the purchase of insurance. As well as to determine the influence of business size, level of education of the owner, Recovery Plan and the knowledge of insurance products on the purchase of insurance by the SME owner. A sample of 322 SMEs in the Nelson Mandela Metropolitan Area South Africa was selected and 203 questionnaires were returned. The results showed that SMEs do not to mitigate risk through the purchase of insurance. The size of the business, level of education, having a Recovery Plan and knowledge of insurance products had an influence on the purchasing of insurance by SME owners/managers for their business.

Keywords: Small and Medium Enterprises (SMEs), Risk, Management, Insurance

1. INTRODUCTION

Running a small business in today's tough environment is hard work and most entrepreneurs start their business without the necessary information on how their business can survive. The key to success is to plan for the future. The owner of a Small and Medium Enterprise (SME) needs to look at the Strengths, Weaknesses, Opportunities and Threats that may affect their business environment, this is also known as a S.W.O.T. analysis. There is a range of variables that can act as a threat to a business, many of which are outside its control, such as tax, legislation and economic conditions. For many of these, there is little that can be done to mitigate the risk to a company at present.

However, where the owner of the business can cover the risk they should try and prevent the risk. There is range of insurance products available to small businesses. They can insure their business against all the threats that may affect their business. This is one important aspect that the SME owner needs to give attention. SME owners/managers need to realise the importance of having insurance policies. It is important for them to view their business as a legacy that continues from generation to generation, not a business that has no future.

It is concerning that the insurance industry prefers to deal only with established businesses and not small businesses (Mthimkhulu, 2008). Short term insurance companies are not eager to insure small enterprises and may even turn them down in some cases. It is more difficult for an SME to address the management of risk, because the owner takes on all managerial roles. In most cases, risk management does not require immediate attention until something happens (Longenecker, et al., 2014). Although small enterprises have been slow to focus on the management of risk, a prudent small business owner will take the time to identify the different types of risks faced by the small enterprise and find ways to cope with them. The knowledge of risk management techniques is essential for the purchase of insurance by SME owners. The size of the business, level of education of the owner and the knowledge of insurance products alone are not an adequate reason for the purchase of insurance to mitigate risk.

2. PURPOSE OF THE STUDY

The purpose of this study is to establish whether SMEs mitigate risk through the purchase of insurance. As well as to determine the influence of business size, level of education of the owner, Recovery Plan and the knowledge of insurance products on the purchase of an insurance policy by the SME owner.

3. RESEARCH PROBLEM

The culture of risk aversion constrains the growth of the SME sector among low-income entrepreneurs (Aliber, 2002; OECD, 2010). This coupled with the insurance industry preference to deal with established businesses and not small businesses (Mthimkhulu, 2008). This creates a problem where SMEs do not have adequate insurance cover to protect their business in the event of a crisis.

4. RESEARCH OBJECTIVES

4.1. Main objective

The main objective of this research was to investigate whether SME owners in the Nelson Mandela Metropolitan Area have an insurance policy to cover their business.

4.2. Secondary objective

The secondary objective of this research was to determine whether the size of the business, level of education, having a Recovery Plan and the knowledge of insurance products influence the purchase of an insurance policy by the SME owner.

4.3. Primary hypothesis

H_1: SMEs in the Nelson Mandela Metropolitan Area mitigate risk through the purchase of insurance.

4.4. Secondary hypothesis

H_2: The size of the business, level of education, having a Recovery Plan and the knowledge of insurance products influence the purchase of an insurance policy by the SME manager or owner.

5. LITERATURE REVIEW

The emergence of new and small enterprises has been recognised as having a significant impact on economic development (Lau & Bsenitz, 2001; Bennett, 2008). The Small and Medium Enterprise (SMEs) owners and managers need to be equipped, to enable them to run their business efficiently and effectively. Most entrepreneurs often start a new enterprise ignorant of many key dimensions of running their enterprises and need to obtain the necessary information if their businesses are to survive (Shepard, Douglas & Shanley, 2000). The key to a successful business is planning ahead, identifying future demands and expectations of customers, ensuring the product or service demanded is available when customers want it and that it satisfies their needs.

As SMEs contribute significantly to the economy it is important that they have an insurance cover for their business. They provide more than 50% of total employment and contribute 45% of the Gross Domestic Product in South Africa (Industrial Development Corporation, 2014).They need to take out health insurance policies for their employees. In the event of an accident they need to have insurance which can help them to compensate their workers. It would be unfortunate in the event that a small business has to use capital funds to compensate their workers. This could lead to the closure of the business because of insufficient capital to continue running the business.

In order for SMEs to achieve growth they should guard themselves against any setbacks that may hinder their progress such as unexpected misfortunes of theft, breakages, fires, strikes and all the other disasters that may befall their business. If a business has an insurance cover they increase their chance to overcome such a situation and continue to run their business.

Insurance represents an important method of meeting the financial consequences of risk. It has been traditionally defined as the business of transforming event (insurable) risks by means of two-party contract. Insurance provides a mechanism for the transfer of the cost of risk rather than the transfer of risk (Valsamakis, Vivian & Du Toit, 2005). When starting a business venture the business owner is taking certain business risks, some of which are unavoidable, but others can be covered by insurance. In any business, the possibility that, years of hard work might be lost due to theft, accidents or a fire should not be ignored. Insurance is usually voluntary, but nevertheless important. The entrepreneur should develop a well-planned insurance policy which can cover these losses by means of insurance payments.

5.1. Risk and insurance

Insurance provides one of the most important means for small firms to transfer business risks. A sound insurance program is imperative for the proper protection of a small business. Many small firms carry insufficient insurance protection. This is a fact that the entrepreneur often comes to realise only after a major loss (Longenecker, *et al.* 2014). The principal value of insurance lies in the reduction of risks from doing business. In buying insurance, the SME trades a potentially large, but uncertain loss for a small but certain one, which is the cost of the premium. In other words, the SME trades in uncertainty for certainty.

Risk is defined as the variation of the actual outcome from the expected outcome (Valsamakis *et al.*, 2005) and a source of randomness that may have an adverse impact on a person or corporation (Culp, 2001). Risk therefore, implies the presence of uncertainty. There may be uncertainty as to the occurrence of an event producing a loss, and uncertainty as regards the outcome of the event (Ritchie & Brindley 2007). The degree of risk is interpreted with reference to the degree of variability and not with reference to the probability that it will display a particular outcome. The standard deviation is a good measure of risk (Valsamakis *et al.*, 2005).

There is no completely satisfactory test that has been formulated to determine if a particular risk is insurable or not. Conceptually most pure risks should be insurable. However, some risks can be pure and non-insurable. For example, the possible destruction of a building due to war is generally not insurable. Usually damage to property, consequential losses arising out of this property, injury to people and liability claims from sudden and accidental events resulting in the above mentioned losses is insurable risks (Valsamakis *et al.*, 2005)

Several classifications of insurance and a variety of policy coverage are available from different insurance companies. Each purchaser of insurance should seek a balance among coverage, deductions and premiums (Longenecker *et al.,* 2014). The rapid growth of the SME sector has brought more focus on this sector with insurers realising that SMEs have different needs and requirements as compared to larger corporations. When it comes to insurance, insurers cannot have a one size fits all approach with SMEs.

Anthony Jackson, general manager of Auto & General Business Insurance in South Africa was quoted by Chiat (2006), saying the following, "It all comes down to risk. A large corporation of more than 200 employees, for example, need a more in-depth insurance and risk analysis which would obviously increase premiums and have huge cost implications. In the SME sector however, the risk is more clearly understood and contained, and a full risk analysis is not really a necessity". This fact has been overlooked by the short term insurance industry, and SME's have also not always been provided with insurance solutions that are relevant to their unique needs. In fact, SMEs have normally been lumped in with large business organisations, resulting in unnecessary and over- priced insurance policies (Chiat, 2006).

In his view, Jackson believes that, to ensure that an SME is adequately looked after from an insurance point of view, the insurance policy must contain the correct combination of traditional policy sections. This means that, there should be no superfluous or irrelevant clauses and features, which, in turn, means that there are no necessary premium costs for the SME. Most importantly, clients should have the flexibility to include additional cover, should it really be of their business. An SME does not need to be insured against all possible risks, but instead, have a policy that is tailor made to suit their business' unique needs (Chiat, 2006).

While risk needs to be managed, yet taking risk is fundamental to doing business (Wu & Olson, 2009). The tools of risk management can include creative risk financing solutions, blending financial, insurance and capital market strategies (Baranoff, 2004).The owner of an SME is therefore expected to take up the role of a risk manager.

The culture of risk aversion constrains the growth of the SME sector among low-income entrepreneurs (Aliber, 2002; OECD, 2010). Micro insurance is one of the ways identified to encourage a positive attitude towards risk aversion (Aliber, 2002). Insurance provides a hedge against risk, yet insurance that might specifically assist SMEs is rear. The only way that insurance that is specifically targeted at SMEs can be developed, is if short-term insurance providers are willing to approach SMEs and establish their needs and offer those products. Risk management strategies concentrated on insurance solutions, with the changes in the business environment, the traditional ways of transferring research are not sufficient. Insurance policies do not cover for all types of risks so there is need to purchase additional insurance policies (Smit, 2012). This can become an expense for SMEs resulting in a need for insurance companies to devise policies that can cover SMEs and their specific needs.

6. METHODOLOGY

An empirical research was carried out and data was collected using a self-administered questionnaire which was distributed to owners or managers of SMEs in the Nelson Mandela Metropolitan area. Data was collected through a structured questionnaire that was developed, pretested and validated. The target population for the research was SME owners or managers within the Nelson Mandela Metropolitan Area. A sampling frame was drawn from the population and from that the actual sample was derived. The sampling technique that was used was cluster sampling. The first cluster had SMEs that had 5 to 20 employees and the second cluster contained SMEs that had 20 to 200 employees. This is based on the definition provided in the South African National Small Business Act of 1996. It was estimated that there were approximately 2400 registered SMEs in the Nelson Mandela Metropolitan Area. The sample size was then calculated using 95% confidence interval with a margin of error of 5%; the sample size was 332 SMEs. There were 203 questionnaires that were returned, which represented a 61% response rate.

The data instrument used to collect data constituted of three sections. Section A had business information and Section B had insurance and business relationship. The instrument was validated and reliability was tested using Chi-square test and Cronbach's alpha. The data was analysed by using Statistical Package for the Social Sciences (SPSS). The statistical methods which were used to analyse the data are descriptive statistics, Cronbach's alpha, correlations, simple regression analysis and Chi-square goodness of fit test.

7. RESEARCH RESULTS

Data will be presented illustrating the importance of the elements that are included in the hypotheses. The main objective of the research was to investigate whether SME owners in the Nelson Mandela Metropolitan Area have an insurance policy to cover their business. The secondary objective was to determine whether the size of the business, level of education, having a Recovery Plan and the knowledge of insurance products influence the purchase of an insurance policy by the SME owner.

7.1. Hypothesis testing

7.1.1. Primary hypothesis

H_1: SMEs in the Nelson Mandela Metropolitan Area mitigate risk through the purchase of insurance.

Table 1. Reliability test on SMEs and insurance policies

Cronbach's Alpha	*Cronbach's Alpha Based on Standardized Items*	*N of Items*
.817	.814	9

The size of the business, having insurance and the type of insurance held, all had high reliabilities, all Cronbach's $\alpha = .82$. Chi-square goodness of fit test is a statistical test commonly used to compare observed data with data we would expect to obtain according to a specific hypothesis. The chi-square test is always testing what scientists call the null hypothesis, which states that there is no significant difference between the expected and the observed result (Garson, 2009). According to our literature review it is expected that SMEs in general do not have insurance policies for their businesses.

The output shows the value of chi-square (χ^2) = .19 and the degrees of freedom on which this was based, was 1. It was tested at 5% level of significance, it was discovered that SMEs do not have insurance policies for their business, with a $p > .05$ ($\chi^2 = .19(1)$ $p=.67$).This means that the alternative hypothesis is rejected and the null hypothesis which states:

SMEs in the Nelson Mandela Metropolitan Area do not mitigate risk through the purchase of insurance is accepted.

Table 2. Chi-square Goodness-of-fit-test on SMEs having an insurance policy

	Have Insurance Policy
Chi-Square	.188[a]
df	1
Asymp. Sig.	.665
Exact Sig.	.718
Point Probability	.105

Note: a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 84.0

There were 41% of the respondents who had insurance policies and 59% did not have insurance. This shows that SMEs in the Nelson Mandela Metropolitan Area do not have insurance for their business.

7.1.2. Secondary hypothesis

H_2: The size of the business, level of education, having a Recovery Plan and the knowledge of insurance products influence the purchase of an insurance policy by the SME owners or managers.

Table 3. Reliability analysis of the responses on having insurance policy, having a Recovery Plan, knowledge of insurance products, education level and size of business

Cronbach's Alpha	*N of Items*
.708	16

The knowledge of insurance policy, having a recovery plan, the knowledge of insurance products, level of education and the size of the business were all statistically reliable with Cronbach's $\alpha = .70$.

Table 4. Simple Regression Model showing the relationship between having an insurance policy and size of business, level of education, having a Recovery Plan and the knowledge of insurance products

Model	*R*	*R Square*	*Adjusted R Square*	*Std. Error of the Estimate*
1	.711[a]	.505	.492	.351

Note: a. Predictors: (Constant), Size Of Business, Aware of insurance Products, Education, Have Recovery Plan

In the model summary above, the results show that the predictors, size of business, product knowledge, education level and having a Recovery Plan are positively related to having an insurance policy with a coefficient of R = .71. The value of $R^2 = .505$, which means that all these predictors account for 50.5% of the variation on whether an SME owner/manager has an insurance policy or they do not have insurance policy for their business.

The Analysis of variance (ANOVA), as well as a regression analysis was used to test the statistical significance of the hypothesis. When tested at a 5% level of significance, results have shown that the size of business, education level of the manager/owner, having a Recovery Plan and knowledge of insurance products plays a significant role in determining the purchase of an insurance policy by SMEs. This can be seen from a p-value = .000.

Table 5. ANOVA showing the relationship between having an insurance policy and the size of the business, level of education, having a Recovery Plan and the knowledge of insurance products

Model		*Sum of Squares*	*Df*	*Mean Square*	*F*	*Sig.*
1	Regression	19.148	4	4.787	38.779	.000[a]
	Residual	18.763	152	.123		
	Total	37.911	156			

Note: a. Predictors: (Constant), Size Of Business, Aware of insurance Products, Education, Have Recovery Plan; b. Dependent Variable: Have Insurance Policy

Coefficients						
Model		*Unstandardized Coefficients*		*Standardized Coefficients*	*t*	*Sig.*
		B	*Std. Error*	*Beta*		
1	(Constant)	2.327	.159		14.662	.000
	Have Recovery Plan	.441	.093	.411	4.731	.000
	Aware of insurance Products	-.193	.089	-.184	-2.164	.032
	Education	-.199	.032	-.373	-6.279	.000
	Size of Business	-.412	.072	-.349	-5.747	.000

Note: a. Dependent Variable: Have Insurance Policy

All the predictors shown in table 5.9 have p<.05. The study results indicate that the size of the business (p= .000), education level of the manager or owner of an SME (p = .000), having a Recovery Plan (p = .000) and knowledge of available insurance products (p = .03) has an impact on whether SME owners/managers have an insurance policy for their business (p = .000). The overall model shows a significant relationship between SME owners/managers who had an insurance policy for their businesses and the four variables named above. This implies that the alternative hypothesis which states the following:

The size of the business, level of education, having a Recovery Plan and the knowledge of insurance products influence the purchase of an insurance policy by the SME owners or managers, is significant at p< .05 and is accepted.

8. CONCLUSIONS

The main objective of this research was to investigate whether SME owners in the Nelson Mandela Metropolitan Area mitigate risk through the purchase of insurance. Through the results a conclusion is reached that SMEs in the Nelson Mandela Metropolitan Area were found not to mitigate risk through the purchase of insurance. The research revealed that 58.7% of the SME owners/managers did not have insurance policies for their businesses. Only 41.3% of SME owners/managers stated that they had insurance policies for their businesses. The research revealed that the size, level of education, having a Recovery Plan and knowledge of insurance products had an influence on the purchasing of an insurance policy by SME owners/managers for their business.

9. MANAGERIAL RECOMMENDATIONS

The owners/managers of SMEs need to be informed about the importance of mitigating risk through the purchase of insurance. There is a big difference between their acknowledgment of the importance of having an insurance policy and them actually having an insurance policy for their businesses. There are risks that may occur such as theft, floods, fires and other natural disasters, because of these and many other disasters that can be faced by small businesses there is need for them to be prepared. The absence of adequate insurance by SME owners/managers has major implications on the SME sector. In the event of a fire, flood or even theft means that the SME owner/manager will have to cover the costs of recovery using funds that were not allocated for such an eventuality, this may result in the business being unable to recover from such a crisis. The business will close down and people will lose their jobs. The responsible bodies such as Small Enterprise Development Agency and Eastern Cape Development Cooperation who offer SME training workshops can use these workshops to train SME owners/managers on the importance of insurance in the survival of their business. Insurance companies should offer workshops to SMEs in order to establish their needs and develop insurance policies that are suitable for the needs for SMEs. The results illustrate that when SME owner/managers who were aware of the insurance products has a correlation with them purchasing insurance for their business.

The South African government can put in place legislation that enforces SME owners/managers to have insurance policies that cover their employees and their assets. This is a sure way of making sure that SMEs are protected from any form of crisis that may disturb the day-to-day running of their businesses. Insurance companies need to carry out more research on their clients. They need to do full need analysis on SMEs where they look at the type of policies that would best suit their businesses and their budget. This is a requirement by law. The Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS), requires any financial services provider to run a needs analysis of their clients before they can offer them any financial products. This law needs to be forced in order for it to protect SMEs.

The needs of SMEs differ with in different sectors and they are also in different financial brackets. One-size-fits-all in terms of insurance becomes impossible. Insurance companies need to carry out research more frequently for them to find out what sort of insurance products and premiums suit the SMEs in different sectors and financial brackets. They can benchmark with other insurance products offered around the world as discussed in the literature review because traditional forms of insurance cover can no longer cater for the risks faced by the modern day organisation.

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