**An Assessment of Small Business Use of Risk Management:**

**An Argument for the Adoption of an Enterprise Risk Management Approach**

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**Abstract**

Businesses of all sizes, types, and structure face a multitude of risks. This paper focuses on small businesses and their approach to risk management and provides an argument for the adoption of an enterprise risk management program. An assessment instrument was administered to over 200 small businesses through a detailed interview process to determine understanding and approaches to risk management. Little evidence was found to indicate that small business owners fully utilize and reap the benefits of risk management. Additionally, it appears small business owners do not seek out information related to risk management other than through the insurance agents they use to meet their personal insurance needs. The authors advocate for an enterprise risk management approach to get business buy-in to the risk management process and optimize risk-taking resulting not only in fewer business failures but also more successful businesses.

**Introduction**

According to data provided by the US Small Business Administration, nearly 2/3 of businesses with employees survive at least 2 years and about 50% survive at least 5 years. As one would expect, after businesses make it through the first few years of volatility, survival rates seem to improve[[1]](#endnote-1). Unfortunately, when bad things happen outside of the owner’s control, it is estimated that 25% of small businesses do not reopen after a disaster. Almost 80% of establishments started in 2014 survived until 2015, the highest share since 2005. From 2004 to 2014, an average of 78.5% of new establishments survived one year. About half of all establishments survive five years or longer. In the past decade, this ranged from a low of 45.4% for establishments started in 2006, and a high of 51.4% for those started in 2011. About one-third of establishments survive 10 years or longer.[[2]](#endnote-2) Given that in 2013, 99.7% of firms in the US were small (500 employees) and small businesses employed approximately 48% of the workforce, anything that can be done to improve success and resilience of small businesses should be of interest.

Academic research has provided many lists of factors that might lead to small business failure. In 1978, Abdelsamad and Kindling provided a qualitative assessment of the reasons why small businesses fail. The authors identified common failure reasons such as excessive optimism, inadequate board members, nepotism, inability to delegate, negligence in developing subordinates, financial pitfalls and underestimation of economic effects. Most of the factors identified were internal as opposed to external. In 1980, Eugene Sirbaugh, then President of Commercial Credit Services Corporation, described the importance of small businesses to the national economy. In his opinion, it was small businesses that provided innovation and job growth; therefore, their survival was of utmost importance. He offered a list of pitfalls for small businesses which included scarcity of venture capital, high interest rates, governmental regulations, taxes, and lack of managerial expertise. His list included both internal and external factors. He encouraged large businesses to partner with small businesses to enhance their chance of survival.

In 1993, Gaskill, Van Auken and Manning concluded that previous research studies had failed to provide a comprehensive list of causes for small business failures. To provide evidence from the field, Lussier (1996) surveyed 100 small business owners that had declared Chapter 11 bankruptcy to identify common reasons for small business failures. The top reasons provided by the former leaders of the failed companies included undercapitalization and high fixed costs, slow economic activity, creditor problems, slow accounts receivable, tax problems, and loss of a major customer. In addition, Lussier offered avoidance measures for business failure that address the identified reasons for failure.

In 1998, Everett and Watson investigated only external factors that led to small business failures. Their research indicated that roughly 30-50% of small business failures were due to external factors such as the cost of borrowing (interest rates), the rate of unemployment and lagged employment rates (cost of personnel), and current and lagged retail sales (a possible measure of the health of the economy).

Goltz (2011) offers 10 reasons small businesses fail. Some of those reasons include out-of-control growth, lack of a cash cushion, operational inefficiencies, dysfunctional management and lack of a succession plan.[[3]](#endnote-3)

Chaney (2016) indicated that small business failures occurred because owners started the business for the wrong reason, had insufficient capital, developed weak plans, provided poor management and leadership, expanded too quickly, and failed to advertise and market appropriately. Similarly, Desjardins (2017) suggested small businesses fail because of cash flow issues, ill-defined markets, poor employee teams, ignoring customers and competitor’s efforts.

Turner and Endres (2017) identified strategies for enhancing small business success rates through a case analysis. In their review, past research studies that identified business failures from an international perspective were provided. Interestingly, most of the reasons were similar to the list identified by US researchers focusing on US small businesses. The list included items such as undercapitalization, not knowing customers, a lack of leadership skills, inefficient operations, and taxes. One addition that Turner and Endres (2017) offered was small business owners’ failure to appropriately use information technology.

While no academic or practitioner research has been identified that clearly and directly ties risk management with business survival, it is reasonable to assume that risk management could have prevented some causes of business failure, e.g. lack of a succession plan, creation of a cash cushion, planning for business cycles, planning appropriate capitalization, etc. But traditional risk management would not have resolved many of the issues related to small business failure. While small businesses have been neglecting risk management, a relatively new approach known as “enterprise risk management” has been getting increasing attention and acceptance from larger firms and risk consulting agencies. Enterprise risk management could be far more effective at failure prevention.

**The Evolution of Risk Management from Traditional to Enterprise Risk Management (ERM)**

The application of enterprise risk management varies widely depending on who is applying it and to whom (or what) it is being applied. The accounting, information security, health care and actuarial industries, to name a few, all have separate, sometimes intertwined, bodies of knowledge relating to the application of enterprise risk management. The concept of enterprise risk management is relatively new, having only been around since the middle 1990s (Dickason 2001). The study of enterprise risk management is even newer and has been limited. Probably the most prolific writers on enterprise risk management are in the area of accounting and audit since Sarbanes Oxley was passed in 2002 and mostly went into effect in 2004. According to the 2017 State of Risk Oversight report published by the North Carolina State Poole College of Management in collaboration with the AICPA, large organizations along with public companies and financial services firms are more mature in their adoption of risk management. However, a large percentage of companies of all sizes are still struggling to integrate their risk assessments and management plans with strategic planning. Small businesses are still lagging behind in the adoption of enterprise risk management (Beasley, Branson, Hancock, 2017).

According to Hoyt and Liebenberg (2015) “there is not much empirical evidence on whether and how [ERM] programs affect corporate values (p. 41)**”.** This article was based primarily on findings from a 2011 study by the same authors which identified only 23 out of 117 publicly traded US insurance companies that had adopted ERM programs. Though the use of ERM even for large insurance companies was minimal, the 2015 study concludes “ERM represents a major shift from managing risks individually to managing risks collectively. (p. 67)” While the enterprise risk management approach has struggled to take hold even for larger and publicly traded organizations, its influence has been almost non-existent among smaller firms.

In an effort to better understand small business use of risk management, assessments were conducted through in-depth interviews with small business owners. The results of the assessments provide evidence that small businesses are not employing even traditional risk management practices and makes the case that in fact, they should be going beyond traditional risk management and employing enterprise risk management. Simply put, enterprise risk management should be utilized to help small businesses achieve all of their objectives, not just to keep bad things from happening or to mitigate their consequences.

**The Case for Applying ERM to Small Businesses**

Traditional risk management focuses on risk mitigation, i.e., the reduction in the frequency and severity of loss. It is focused almost exclusively on loss caused by pure risk or risk that cannot lead to positive outcomes such as fire damage to property, lost wage indemnity because of injury to workers, or liability resulting from a product defect. These are sometimes referred to as “hazard risks”. But if you look at risk management from the standpoint of mitigating loss, the most effective way to mitigate risk is to avoid it. Imagine a business that avoids all risk. Risk-taking is an inherent part of business.

Enterprise risk management theorists generally establish four quadrants of risk that should be considered when managing risk: hazard, operational, strategic, and financial. An enterprise risk management approach focuses, therefore, not just on hazard risks like fire, wind, liability, and worker injury, but also on operational risks like data entry error and technology obsolescence, or strategic risks like competition and customer satisfaction or financial risks, such as asset liquidity and credit risks. It focuses on risk optimization toward the achievement of the small business’s objectives.

**Benefits of Enterprise Risk Management for Small Businesses**

When using an ERM approach to risk management, crossovers between different quadrants of risk become apparent. For example, consider a business that is deciding whether or not to sell its products online. Think of the risks that exist in every quadrant of risk: hazard risk includes potential liability for identify theft, operational risk includes the risk associated with the functionality of technology, financial risk includes the increased credit risk assumed, and strategic risk includes the expansion of the market and the new customer demographics that can now be reached. These crossovers are part of what necessitate the use of ERM to achieve risk management success or risk-optimization.

We can define risk optimization as the equilibrium where the business achieves the highest return (considering their objectives) for the lowest cost. ERM is more effective at achieving risk optimization because implementing one treatment method might lead to improved risk outcomes in one quadrant, but worse risk outcomes in another quadrant leading to an overall net negative impact. For example, implementing safety measures to prevent worker injury might result in significantly reduced productivity. When taking an ERM approach, a business owner is likely to identify a more effective method, such as using technology, to both prevent worker injury and increase productivity.

Risk management is often not viewed as a priority for business owners, primarily because it has historically focused on pure risks and, therefore, provides no potential up-side. A critical component of a successful risk management process for a small business is to convince the business owner and other business stakeholders that risk management should be a priority. This can be done by tying a business’s risk management strategy to its overall business objectives (especially a small business). This process is imperative for a successful risk management program.

The idea is that instead of just asking “what property would you lose in a fire?” or “who might sue you?” or “what kind of insurance do you have?” we first ask “what are your business objectives?” Besides income, what do you want to accomplish? Independence? Jobs for others? A high quality product or service? These questions should be asked at the very beginning of any risk assessment because they are critically important to help a business understand how to optimize risk-taking.

**Previous Studies Related to Small Business Use of Risk Management**

In 1984, Hollman and Zadeh provided an overview of the risk management function and its importance for small businesses for operating more efficiently and creating a more sustainable business model. Hollman and Zadeh’s work was one of the first to argue for the application of risk management to small businesses and to provide a framework for addressing small business risk management issues.

After concluding through an intake survey after a disaster that small business owners lacked understanding of risk management tools and techniques, including disaster recover, Berry and Dunn (2010) reviewed educational material and academic journals and found a scarcity of material related to risk management for small businesses. They called for additional research to benchmark the current understanding of risk management among small businesses and the development of educational tools so that small business owners could gain a better understanding of risk management and its practical usefulness.

Verbani and Venturini (2011) defined nine streams of risk management research areas: strategic risk management, financial risk management, enterprise risk management, insurance risk management, project risk management, engineering risk management, supply chain risk management, disaster risk management, and clinical risk management. Several authors, including Acar and Goc (2011), looked at the impact that owner characteristics had on risk management in small businesses. These authors studied Turkish construction company owners’ psychological and demographic traits impact on their risk perception of construction projects. They concluded that a significant impact existed.

Verbani and Venturini (2013) later provided a literature review for the time period between 1999 and 2009 and proposed a research agenda for those interested in risk management in small and medium enterprises. In their study, the authors considered different perspectives of the type of research and type of risk (hazard, financial, operational, and strategic). During the review, the authors identified only 33 publications for review, including those appearing in conference proceedings. A majority of the papers included in the analysis were empirical in nature and investigated operational risks, mostly those dealing with information technology. Their analysis showed that little attention had been given to address the other types of risks (hazard, financial, and strategic). Verbani and Venturini suggested that specific instruments be developed for evaluating the human resource perspective of risk management in small businesses and that the overall attention given to risk management in small businesses was lacking.

Since 2013, many authors have addressed numerous aspects of risk management in small businesses. Mitka (2015) investigated how gender of firm’s ownership impacts the approach to risk management. After studying 299 companies, Mitka concluded that gender did not impact the approach to risk management. Florescu, Barabas and Barabas (2015) conducted a case analysis of a company to conclude that risk management should become part of the culture of enterprises to lead to success. Risk management should evolve and grow through an organization to reap the benefits of a strong risk management program.

In a recent article, Pablo, Hoberman, Jerah, and Jordao (2016) discuss the importance of disaster risk management for small and medium sized businesses’ resilience and continuity. The authors describe a collaborative program between Florida International University’s Small Business Development Center and the Extreme Events Institute to provide education regarding disaster risk management across south Florida and Latin America. The authors reported that 56% of small business respondents in their survey did not have a business continuity plan in place and that companies with fewer employees are less likely to have business continuity plans when compared to larger employers (14.1 % with less than 100 employees compared to 37.2% with at least 500 employees).

**Data Collection Methodology**

As part of a 2010 federal grant to improve small business resilience after a disaster, a program was created to assess small business understanding and use of risk management tools and techniques. This program included a group of disaster recovery consultants that were expected to interview small business owners and administer a survey to determine risk management needs and provide advice to meet the unmet needs and or risks. Business owners were reluctant to visit with the business continuity consultants; however, business owners were almost always willing to visit with trained students and complete the assessment instruments. The instrument has been modified and improved each year since 2010.

**The Assessment Instrument**

The assessment instrument includes business demographic questions such as location of business, number of owners, type of business, number of employees, number of locations, and value of gross sales and property values. Section two addresses the reasons why the business was started. It includes questions such as “why did you start this business,” “did you start this business, as opposed to buying it from someone else,” “does your spouse work for the business,” “how many hours per week to you spend running your business,” and “rate your enjoyment of running your business.” Section three addresses future plans of the business owner for the business (how much longer do you plan to own the business, please tell us what future you have planned for the business). Section four seeks to determine if other businesses are owned by the owner or whether the owner plans to start another business.

Section five includes questions about business partners (life insurance, succession plans, mission statement) while section six collects demographic data about the primary owner (gender, age, education level). Section six includes a list of types of losses (e.g., employee theft, other burglary, and business vehicle damage) and asks owners the frequency and severity of the losses over the past five years.

Sections seven, eight, and nine focus on how the business attempts to control risk, i.e. to reduce the frequency and severity of losses. Section seven includes questions related to information technology risks (virus protection, firewall, backup, IT use policies, passwords, and other forms of security).

Section eight includes employee risks, from recruiting, hiring, security, and financial risks. Section nine addresses business continuity and emergency preparedness and asks about written emergency preparedness plans and written business continuity plans.

Finally, the last section covers how the business finances risk, i.e. how they pay for losses that occur. Since small businesses are rarely able to self-insure, the focus is on the types of private insurance purchased to pay for losses to the businesses. Additionally, questions are asked about the insurance agent that was used to purchase the policy. Additionally, the last section asks why the business owner chose not to purchase a business owner’s policy, commercial property policy, business interruption policy, commercial auto policy, workers compensation policy, professional liability policy, or flood insurance policy.

**Respondent Demographics**

Two hundred and two business assessments from across Louisiana and nineteen from other states were analyzed for this paper. Of the respondents, 61% were owned by one person, while 24% were owned by two people. As far as longevity in business, over 40 businesses had been in business over 20 years, and nearly 50 had been in business 5 to 10 years. Over half of the responses had been in business for over 2 years. The majority of the respondents included businesses with 5 or fewer employees and those that had sales greater than $100,000 (62%) and property valued greater than $100,000 (67%). The types of businesses were mostly retail trade (38%) and services (35%). Twelve percent of the businesses considered themselves to be home-based businesses.

**Results**

When asked about critical risks faced by the small business, five areas seemed to be important to most respondents. The top five critical risks identified were the ability of people to come into and out of their place of business (82%), computers and associated risks (63%), inventory (62%), specialized equipment (61%), and internet access (55%).

Risk Control

In the area of risk control, respondents were asked about how they controlled risk in various areas, including technology, employees, planning, emergency and business continuity planning, and succession planning.

In the area of technology, respondents who used computers indicated a relatively high level of risk control. A majority had installed a firewall and anti-virus software for their computers, 35% indicated they backed-up their critical data on a daily or more frequent basic and only 12% indicated they never back-up their critical data.

In the area of employees, 82% of businesses that had employees indicated they check references but only 43% indicated they conduct background checks on potential hires. Seventy-four percent communicate an ethics policy to employees and 63% utilize security cameras.

The businesses surveyed were the weakest in the area of planning in terms of risk control. Sixty-eight percent indicated they did not have an emergency plan in place and 4% did not know whether they had this type of plan in place. In terms of a business continuity plan, an even larger percentage, 71%, did not have a business continuity plan and 10% were not sure. This high percentage of “not sure” responses might be because of some confusion about a business continuity plan. A business continuity plan is distinct from an emergency plan in that business continuity focuses on longer-term sustainability. An emergency plan includes the actions a business plans to take in the immediate aftermath of a disaster or other accident whereas a business continuity plan includes the strategic actions a business plans to take to ensure the long-term success of the business after a disaster or other occurrence that negatively impacts the business.

When asked about the future of the business, 43% of the respondents indicated they had not thought about their final plans for their business. Some planned to pass their business on to family members while some planned to sell the business to outsiders. Fifty-six percent of the respondents had no succession plans in place in the event one of the owners was no longer able to run the business and similarly, 56% did not have life insurance on their key business partner.

Risk Financing

As shown in Figure 1, respondents indicated they carried various types of insurance policies to finance their risks.

General liability was carried by over 70% of the respondents, while 65% had a business owner’s policy and 53% had a commercial property policy. It is not surprising that the majority of businesses had a general liability policy (GL) since many times businesses are required to carry a GL when they subcontract with other firms. It is also not surprising that the majority of businesses carry property insurance since a loan on property generally requires the purchase of property insurance. Business owner’s policies (BOP) covers many of the same exposures that a general liability policy and a commercial property policy cover. Their stated reasons for not purchasing insurance are discussed in the next section and will shed more light on the appropriateness of their decisions.

Forty-eight percent of respondents had worker’s compensation though only 28% did not have employees. Interestingly, only 10% carried an electronic data processing policy and 11% carried business interruption insurance.

Figure 2 shows the percentage of businesses that were not sure whether they had a certain type of insurance. Though these numbers are relatively small, it is concerning that any business owner would not know what types of insurance protects its business. If the business has a loss, how would they know to make a claim for the loss if they are unsure what type of insurance they carry. Some of this confusion might relate to the lack of understanding about what the policies they do carry actually cover. For example, they might be unsure whether or not they have professional liability coverage because they do not know whether a general liability policy covers professional liability. It does not.

**Reasons for Insurance Decisions**

Of those respondents who did not have a Business Owner’s Policy (BOP), 11% did not believe that their business had exposures that would be covered by a BOP and only 5% stated that the exposures were covered by other insurance. It is unlikely that a business would not have any property, at least a computer, inventory or equipment that could be covered by the BOP. Even more concerning is that a total of 11% of businesses who did not have a BOP stated that it was related to one of the following: the agent didn’t recommend it, it was overpriced, they expected to have no losses, or they did not want to spend the money.

While the majority of businesses did purchase a GL, a total of 12% stated they did not have a GL because they do not believe they have the exposures, they expect no losses, or they do not want to spend the money.

Twenty percent of respondents who chose not to have a worker’s compensation policy indicated they preferred to pay losses out of pocket while 16% indicated they just did not want to spend the money on worker’s compensation insurance. In most states, a business is legally required to purchase workers’ compensation or provide evidence of the ability to self-insurer even if they have one part-time employee. Evidence of the ability to self-insure usually requires a significant securities deposit with the state, a contract with a third-party administrator, and the purchase of excess insurance.

Of those respondents who did not purchase flood insurance, 35% indicated they were not in a flood zone and another 35% said they expected no loss. The reality is that every property in the US is in a flood zone and nearly every property is susceptible to flood loss. Flood zones are designated by the National Flood Insurance Program (NFIP) to determine rates charged for flood insurance but all areas have some flood zone designation. It is the case that only properties in certain flood zones are required to purchase flood insurance by federally insured banks that make loans on those properties. However, as stated on the NFIP website, floodsmart.gov more than 20% of flood insurance claims come from people out of mapped high-risk flood areas. (NFIP, 2016).

Forty percent of the respondents indicated they purchased their business insurance from the same agent that provided them their homeowners or personal automobile insurance. While purchasing insurance on a business from the same agent who the business owner obtains his or her homeowners insurance is likely comfortable and convenient, it is not necessarily the best option.

Business risk exposures are typically more complex than personal exposures and require the expertise of individuals specialized in understanding the particular types of exposures and coverage needs of a business. An agent that has expertise in understanding the nature of homeowners and auto risk is not as likely to be expert in the much wider variety of risks affecting a small business owner. For example, a small business owners might have professional liability exposures, cyber security exposures, employee injury, and business income exposures that an individual or family do not have.

Adding to the problem of using the same agent to purchase personal insurance to find business insurance is that a significant percentage of personal insurance is sold by captive insurance agents. A captive agent, by nature only represents one company whereas an independent agent can sell insurance from any company that appoints the agent. An independent agent can therefore select the best coverage from many different companies for its clients. Independent agents tend to specialize in either personal insurance or commercial insurance and are more likely to specialize in a particular type of business or a type of commercial insurance than a captive agent. For example, an independent agent might specialize in commercial trucking or in workers’ compensation. Because an independent agent is more likely to specialize, it is more practical for that agent to understand all aspects of that business, not just those risks that can be insured, but also those which cannot be insured. An independent agent is, therefore, more likely to take an enterprise risk management approach to helping a business owner manage risk and has more options to treat the risks than a captive agent.

When asked from what type of agent the business owner purchased the majority of their insurance, 37% of respondents indicated they used captive agents while 55% used independent agents (8% were unsure what type of agent was used). This is not surprising since, according to 2016 statisticsprovided bythe Louisiana Department of Insurance (2016), approximately 46% of homeowners insurance and 55% of personal auto purchased in Louisiana was purchased from companies that use the captive agency system to sell their products .

**Summary**

To improve risk management for small businesses, it is recommended that small businesses take an enterprise risk management approach to managing risk. Approaching risk management using an enterprise risk management framework actually has two distinct but equally important benefits: achieving risk optimization instead of risk mitigation and successfully attaining long-term business owner buy-in to the risk management process.

In this paper, evidence was provided that small businesses do not adequately manage risk. The following weaknesses in the small business risk management approach were identified:

* Not having a business continuity plan
* Making decisions not to purchase (and in some cases to purchase) based on incorrect rationale
* Not knowing what types of insurance they have
* Relying solely on their insurance agent for risk management guidance
* Using insurance agents who are not experts on their type of business’s risks or even business risks in general

As evidenced from our surveys, small business owners rely on their insurance agents to tell them what type of insurance to purchase and appear to consider the purchase of insurance their risk management plan. Business owners who rely heavily only on their insurance agent for risk management guidance will tend to focus only on risks that are insurable and only use insurance to manage those risks. While insurance is typically an important part of any risk management program as it can be an effective tool in transferring the financial cost of certain hazard risks, focusing on just hazard risk quadrant does not take into account crossovers into the operational, financial or strategic risks quadrants.

Using an ERM approach to risk management, a business owner will consider risks that exist in the four quadrants and make better strategic decisions. Additionally, by considering all four risk quadrants, the business owner will be able to see the benefits of managing risk and will take a more active role in risk management. The authors advocate for an enterprise risk management approach to get business buy-in to the risk management process and optimize risk-taking resulting not only in fewer business failures but also more successful businesses.

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**End Notes**

1. (<https://www.sba.gov/sites/default/files/Business-Survival.pdf>). [↑](#endnote-ref-1)
2. United States Small Business Administration Office of Advocacy. 2016. Frequently Asked Questions, https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016\_WEB.pdf. [↑](#endnote-ref-2)
3. (<http://boss.blogs.nytimes.com/2011/01/05/top-10-reasons-small-businesses-fail/?_r=0>). [↑](#endnote-ref-3)