



## **An Assessment of Risk Management Practices of SME Taxpayers in Malawi and their Impact on Tax Compliance**

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**Abstract:** This study assesses understanding of Risk, and extent of risk management practices in Small and Medium Enterprise (SME) taxpayers in Malawi, subsequently, investigates their relationship with financial performance and tax compliance. The study focuses on unlimited business sectors of SME taxpayers which drew a representation of our sample of 324 SMEs, using Partial Least Square-Structural Equation Modeling (PLS-SEM) to analyze and test hypotheses. Results indicate that half of the SME taxpayers are aware of risks, but only 23% of respondents underwent any training on risk management. 90% of respondents revealed that tax rates are the most significant business constraint; value-added tax (VAT) being the most challenging tax to file. Most respondents identified risks through experience, with risk management practices centering on Chief Executive Officers. Empirical evidence on Path analysis and bootstrapping results established a significant relationship between understanding risks, risk management practices, financial performance and Tax compliance, which is positive, signaling a road map for risk mitigation if tax administration is to widen its SME tax net.

**Keywords:** Tax administration, Understanding risk, Risk management practices, Tax compliance, Financial performance, SME taxpayers

### **1. Introduction**

Every government needs funds to finance its budget, taxes being the main source. A number of reasons are outlined for the imposition of taxes, one being raising money for provision of public services such as health, education, defense, security and maintenance of law and order (Gangl et al., 2015). According to FIRS (2012), a tax is a compulsory donation from individuals and property possession imposed by the government, by its powers guided by tax laws. As such, Taxation is confiscatory (Berkowitz & Li 1999). Because of its confiscatory nature, Taxpayers will always minimize tax payable through tax avoidance, evasion and more other ways that are convenient for them. As a result, tax administrators face many challenges in collecting taxes let alone improving compliance as compliance costs rise due to corruption, evasion, and increase in informal sector among others.

#### **1.1 Tax Administration**

There are four main compliance obligations of a taxpayer that is core to tax administration business fundamentals. These are registration, the filing of tax returns, assessment of tax due, and making sure that tax liability is paid at the right time and, in the right manner (Kangave, 2005). Penalties are imposed on the unpaid amount of tax. Achieving voluntary compliance is a challenge to tax administration due to the conflict it encounters with taxpayers who minimize what they ought to pay to the government, either through tax avoidance or evasion. This inability to manage compliance impacts on the revenue collections which are usually low.

Many tax administrations have implemented strategies to improve compliance, thereby increasing revenue collection. These strategies include; taxpayer education, an introduction of risk management units, innovative enforcement

measures, and reorganization based on services provided (McCartney, 2003). Irrespective of adopting these measures, there still appears tax gap in the revenue administration (Harmelink et al., 2003).

## **1.2 Tax Compliance and Risk Management**

To effectively provide quality services to taxpayers, tax administrations have established and adopted Risk management making them risk-oriented. Functions and processes are analyzed to identify risky areas and adopt a strategy which addresses these risks (Long 1991). Risk management helps tax administration focus on its objectives to accomplish its goals of maximizing revenue collection, by making better decisions in its risk management processes. Through laid down procedures, management has to identify, assess, treat and evaluate risks.

In modern tax administration, enterprise risk management units (ERM) are established and adopted into performance management systems and the business plans as part of compliance goals, even though Arena (2010) in his study regarding benefits of ERM, argues that ERM is just a compliance tool. Although it is new to tax administration, tremendous improvements are noted in some revenue authorities including Canada (Kleffner, 2003). The risks identified have been mitigated or eliminated.

## **1.3 SME Taxpayers**

To better identify, understand and deal with risks, recommended by the international monetary fund (IMF), tax administrations have segmented taxpayers into large and small & medium enterprises (SMEs). The reason is that size of the taxpayer has different characteristics, and each group presents different risks. Therefore, each segment requires its own set of strategies (Bodin, 2010). Most tax administrations have focused mainly on large taxpayers as they contribute more tax revenues; Malawi is not an exception, as over 70 % of revenues come from large taxpayers who are about 600, against over 52, 000 SMEs who contribute about 30% of total tax revenues (Malawi revenue collection reports, 2011-2017). In Benin, SMEs share is about 9%, Kenya: 49%. In China, SMEs contribute to 99% of China's economy and 60% to GDP; generates 82% of employment (IMF WP 16/68 2016).

Below is an analysis of SME tax revenue performance in Malawi.

**Table 1:** SME Tax revenue performance, and as a share of total taxes (2011-2017) in billions of Malawi Kwacha

	<b>Total taxes</b>	<b>Large taxpayers</b>	<b>SMEs</b>	<b>SME % of total tax</b>
2011	111,376.40	74,505.00	36,871.40	33.1
2012	130,345.90	88,581.30	41,764.60	32.0
2013	181,709.70	125,225.40	56,484.30	31.1
2014	253,940.90	175,018.10	78,922.80	31.1
2015	319,310.20	216,423.00	102,887.20	32.2
2016	390,337.90	245,540.90	144,797.00	37.1
2017	436,131.40	286,422.40	149,709.00	34.3

**Source:** Author computation

To mitigate risks associated with SME non-compliance, Tax administration in Malawi has implemented a number of strategies either as deterrence measures or as a treatment to factors that encourage such behaviors. These include taxpayer education, exemption from penalties for voluntary disclosure of underpayments, adoption of an electronic fiscal device (EFDs) as risk management innovation, modernization of its systems. There has been a minimal impact as SMEs are numerous, difficult to handle, therefore making them risky group. Moreover, they are challenged with limited management skills and formal education, access to credit, lack of technical know-how and inability to acquire skills and modern technology. Further to this, SMEs lack access to credit (Basteri 2016), a poor keeping of business transactions leaving no audit trail (OECD, 2004). Despite all the initiatives taken by tax administration in improving tax compliance in Malawi, SMEs overall compliance level remains as low as 30% (2015/2016 MRA Annual Operations Report).

To address this gap in SME taxpayers, the study assessed, understanding and extent of risk management practices by SME in Malawi, how they affect their operations, and subsequently, investigate the relationship between understanding risk, risk management practices, financial performance and tax compliance. Consequently tax administration will make more informed decisions in identifying strategies that will improve tax compliance. This could be achieved through collaboration in managing SME established policies while helping them manage their business risks, or reinforcing cooperation with SMEs by engaging in knowledge sharing, training and exchanges of information on good risk management practices which will have an impact on tax. The study adopted Structural Equation Modeling Partial Least Square (PLS-SEM 3.0) to test the relationship between risk management practices, understanding risk, financial performance and tax compliance, in measuring the fitness of the suggested model (Hair, Ringle & Sarstedt, 2011). The study also implored descriptive statistics to evaluate the extent of risk management practices in SMEs in Malawi.

## **2. Risk Literature Review**

### **2.1 Management and Risk Management Practices in SMEs**

A risk is a result of an action in gaining something foreseen or inaction in losing something unforeseen. Skipper (1999), emphasized that risk has no universal definition but, it is a variation of outcomes. However, Shimpi (1997) described it as the lifeblood of every organization, moreover ISO (31000), concurred that; it is an integral part of all organizations. Several studies have assessed risk management practices in SMEs in different countries, including, Ghana (Djan & Zehou 2017), Zimbabwe (Gwangwava et al. 2014), Indonesia (Wiryono 2014), Germany (Henschel 2006) and South Africa (Yolande 2012). These focused on evaluation, identification, analysis, and treatment of operational, financial, and strategic risks. A study by Brustbauer, (2014), Kim & Vonortas (2014), Acar & Goc (2011) indicate that the risk management practices are influenced by ownership characteristics, size, and structure of SME. In a study by Acar and Goc, 2011, it was noted that owner-managers are less risk averse, therefore, do not focus on business strategies with more probability of risks. In agreement to this, Gilmore et al. (2004) noted that culture, gender and age influences risk appetite and tolerance. Younger managers are more informed about risk situations and make informed decisions in mitigating the risks. In the same line, male SME owners have more risk appetite than female, and younger managers are more risk tolerant and have a huge appetite for risk than aging managers especially if they are more educated. On culture, managers from the western world take more risks than developing world.

Risk identification is critical to risk management practices as it has an influence on risk analysis if risks are poorly identified (GAO et al., 2013). Level of staff knowledge on risk influences efficiency and ability in risk identification process (Bruns & Fletcher 2008, Ellegaard 2008). Moreover, SMEs lack of skills, and limited human and financial capability may also impact on effective identification and management of risks. There is however limited literature on how SMEs must identify risks, apart from using the financial indicators which indicate the loss. Marcelino-Sádaba et al., (2014) in his study on risk analysis suggested that SMEs must adopt two methods due to the limited knowledge of the employees, the probability, and the gravity. With regard to risk assessment, implementation and control in SMEs, managers tend to delegate to other employees their duties especially senior staff as a way of managing risks (Gilmore et al., 2004), or transfer the risks to investors. Hollman & Zadeth (1984) suggested that SMEs need to define their performance standard in the quest to evaluate their risks.

As discussed earlier, the main risks identified in the literature are financial risks, operations risk, market risks and strategic risks. This is evident in studies on financial risks which indicated that the main types of risks in SMEs are Interest rate risk, (Mutezo 2013, Gwangwava 2014, Altman et al., 2010; Gama and Gerales 2012). Loans being their main option of financing their business finances, SMEs are susceptible to loan interest, however, with limited loan guarantee; chances of a loan are slim (Bruns and Fletcher (2008).

Literature shows that Operation risks are also critical in SMEs (Klemen & Biffel, 2002, Poba 2000, Nzaou et al., 2008, Ellegaard, 2008). A study on staff and management by Sukumaretal (2011), suggests that lack of employee development program poses a risk of continuity, as skills are possessed normally with very few or one individual who when leaves is a great risk to the SMEs. In the same vein, there is a risk of growth in SMEs as there are limited key people in the know how (Marcellino Sadabaetal 2016). The other risks faced by SMEs include raw material risks (Moore 2000), supply chain risks (Ellegard 2008), and credit card risks (Poba 2000).

### **2.2 Understanding Risks**

Risks are unpredictable, associated with the probability of occurrence and consequences (Miles & Snow 1978). Hence

managers or business owners must understand risks and its impact on business. A study done on SMEs in Zimbabwe on understanding risks indicate that SME operators expressed ignorance on the understanding of risk, and not more than 10% could define risk (Gwangwava et al., 2014). The understanding of what risk represents differs from organizations and also at different levels of management. Risk management process needs to develop a common risk vocabulary so that the understanding of risks is not just with the top echelon of the organization (Muralidhar, 2010). There has to be guidance on risk management processes which include risk assessment so that SMEs can improve their efficiency (O'hara et al., 2005). In the same vein, knowledge, and understanding of taxes has an impact on tax compliance. Kirchler et al., (2008) stated that higher knowledge concerning tax leads to higher compliance, the opposite is true.

### **2.3 SME Financial Performance**

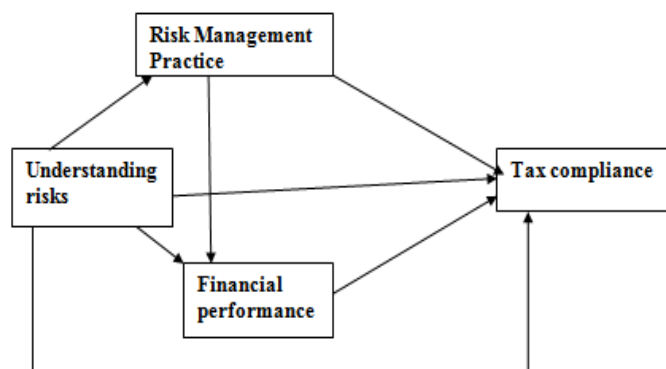
As the firm determines its operating performance and financial status, it also defines its tax capabilities measured by a financial statement which is the most important diagnostic tools for the informed manager (Ozgulbas et al., 2012). Many SMEs use profitability ratios to measure their business performance. According to literature, many studies reveal that depending on the nature of their business which is not large scale, SMEs measure financial performance using profitability ratios (Gruian, 2011; Johnson, 1987; Kakani 2001; Cross et al., 1995). In his study on setting SMEs early warning financial risks, Koyuncugil et al.,(2012), identified ratios of operating expenses to net profit, gross profit to net sales, profit before tax, to measure financial performance. However, there seems to be no strict measure in SMEs for financial performance. Some studies (Ramanujan et al., 1996) have indicated that performance measure should include both quantitative and qualitative measures. Qualitative measures include market innovation.

A study by Ritsema & Thomas (2003) indicated that tax owed is directly influenced by income level. If SMEs fail to manage their businesses in terms of risks, it could affect their income; which inversely has proven to have an impact on non-compliance as per a study by Young (1994). On the same note, under the theory of ability to pay, Fischer et al., (1992) noted that income levels define how much taxes to be paid, this, therefore, influences tax compliance as the more the ability to pay, the more the taxes. However, a study by Basteri et al., (2016) found no relationship between the two but confirmed the theory of willingness to pay, to be affected by optimal tax system where taxpayers will be willing to pay if tax administration systems are well implemented. This means that a good tax system is a motivator to optimum tax reporting. Optimal tax reporting indicators include gross profit, operational profit, benchmarking of gross profit, and performance using cost of sales, the return of asset among others .

## **3. Methodology and Conceptual Framework**

### **3.1 Conceptual Framework**

Risk management practices may affect the extent of risk management thereby having an impact on compliance levels of a taxpayer (OECD, 2004). In this research, we test this relationship. The study set latent variables as tax compliance, risk management practices, financial performance and understanding risks. Risk management practices measured by risk identification, risk assessment, risk response, monitoring, and review. Financial performance efficiency is measured by profitability and revenue growth. Tax Compliance measured by the fairness of tax system, tax evasion and willingness to pay taxes. Based on the understanding above, a conceptual model with five hypotheses was tested empirically to investigate the relation below in Fig 1.



**Figure 1: Conceptual Model for the study**

**Source:** Author compilation

The following hypotheses were set as below in testing the above model in figure 1:

Hypothesis 1: Risk management practices have a positive relationship with tax compliance

Hypothesis 2: Risk management practices in SMEs have an effect on financial performance

Hypothesis 3: Understanding risks affects risk management practices

Hypothesis 4: Understanding risks have an impact on Tax compliance

Hypothesis 5: Understanding risk affects on financial performance

Hypothesis 6: Financial performance has a significant influence on Tax Compliance

### **3.2 Methodology**

This study focused on unlimited business sectors of SME taxpayers which drew a representation of our sample. The purpose of the survey was to examine degree and understanding of risk management practices of SME taxpayers in Malawi by asking the respondents questions relating to risk management processes and how they deal with all aspects of risk linked to the achievement of the company's objectives. Questions contained a statement of multiple response questions and Text response. The questionnaire used Likert scale (Zikmund W. G., 2002) to formulate and weight the ratings.

Data of firms was obtained from SMEs through an online survey and hand delivery of questionnaires. Data was collected from 324 SME taxpayers. No distinction was made between the types of company. Respondents were key persons in the entrepreneurship of SME firms who were responsible for the performance and growth of the enterprises. The study used Partial Least Square-Structural Equation Model (PLS-SEM) to test the hypotheses. The choice was for different reasons. Firstly, because the aim of this study was to test and verify the relationship between risk management practices, understanding risk, financial performance and tax compliance, it evaluated and measured model fit through the quality of data, as suggested by Hair, Ringle & Sarstedt (2011). Secondly, PLS method was aimed to analyze the causal predictiveness. SEM is more useful for estimating latent variables in the measurement model and simultaneously tests multiple relationships of the constructs in the structural model (Hair, Sarstedt, and Ringle & Mena 2012).

## **4. Results and Discussion**

### **4.1 Demographic Data**

The study reveals that 44% of SME respondents were female, while 56% were male. 88% of the sample was in retail/whole selling, 6.5% in the manufacture, 4.7% in farming while 1.8% in mining. 41% are diploma holders, 34% are graduates, 16% hold secondary school certificate, while 10% hold Master degree.

### **4.2 Risk Management Practices**

In this study, an analysis of risk management practices of SMEs indicated that 51% of SMEs are aware of risk management, of which about half (53%) disagreed that they underwent neither risk management strategy training nor risk-taking training. However when faced with different risks, 83% face market risks. Owner managers were responsible for handling risks according to 90% of the respondents. 80% of the respondents further explained that they identify risks from the source and experience. On tax administration efficiency, the most challenging tax to file is VAT contrary to a study done by European Union 2009 on many countries survey, which showed that it was income tax. 53% of the respondents suggested that they avoid risks when applying risk treatment strategies, contrary to study by Magro & Kellow (2012), which indicated that businesses would accept the risk if the cost of implementation outweighs the cost of mitigation. When asked how they benchmark their business performance, 82% of sample respondents use the cost of sales as per a study by Ozgulbas & Koyuncil (2012), which used the cost of sales to analyze the financial performance of SMEs. 90% of their business constraint is tax rates; this is in agreement to a study done in Ghana where about 80% of the respondents said rates are unfair (Tee et al., 2016). Respondents complaints about high tax rates might be a source of non-compliance as it might imply lack of fairness in the tax system.

### **4.3 Measurement Model**

In PLS, we evaluate the inner model fit using the measurement model. This is done by testing the validity and the reliability of the indicators. While the former indicates the ability of the indicators to represent the concept, the latter illustrates the stability and consistency of the indicators in measuring the concept (Sekaran & Bougies, 2012).

Normally, Cronbach’s alpha measures the internal consistency of the measurement model by determining how all items on a test are relating to each other, expressed as a coefficient between 0 and 1. The higher coefficient is an indication of better consistency. By implication, a scale of 0.7 is acceptable, while equal to or greater than 0.80 is good.

To test the internal consistency and reliability of latent variables, Composite reliability is used (Hair et al., 2012). A scale of greater than 0.7 is believed to be a satisfactory indicator, while a scale of between 0.6 and 0.7 is considered, a scale of less than 0.6 indicate the absence of reliability. As displayed in table 1, all constructs displayed composite reliability of between 0.89 and 0.90, which are well above the threshold value of 0.7

Convergent validity was tested to test the validity of the constructs using average variance extracted (AVE), (Hair et al., 2012). Recommended AVE is equal to or greater than 0.05. As shown in table 2, the AVE values for all constructs were within the range of 0.543 and 0.811, confirming that the convergent validity of measurement of constructs was supported.

**Table 2:** Construct Reliability and Validity

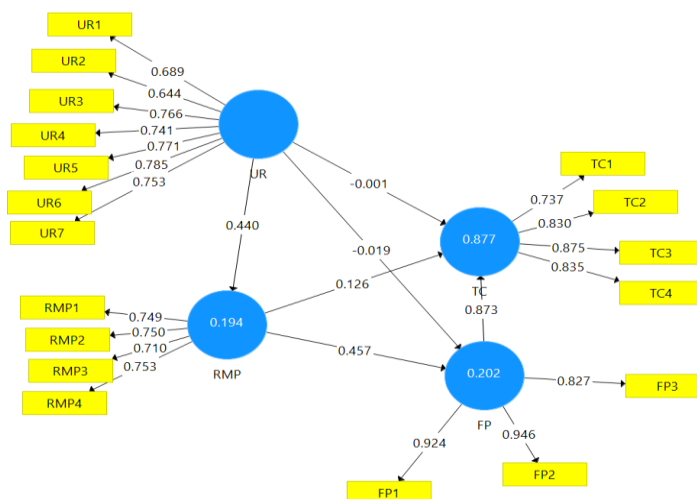
Constructs	Cronbach's Alpha	rho_A	Composite Reliability	Average Variance Extracted (AVE)
FP	0.882	0.884	0.908	0.811
RMP	0.726	0.727	0.829	0.549
TC	0.841	0.870	0.892	0.674
UR	0.868	0.886	0.892	0.543

To test how the indicators are related to its construct than the others, discriminant validity was used. Table 3 summarizes the results, where measured constructs loaded less on other constructs but highly on its measurement items

**Table 3:** Discriminant Validity

	FP	RMP	TC	UR
FP	0.901			
RMP	0.313	0.741		
TC	0.347	0.318	0.821	
UR	0.182	0.340	0.214	0.737

**4.4 Path Analysis Relationship**



**Figure1:** Model Path Coefficient

Standardized Path coefficient weights range from -1 to +1, which means that a range closest to 1 indicates stronger paths while those closer to 0 indicate weaker paths. The analysis of the proposed direct path of the relationship among RU, RMP, RM, and TC was highlighted below as per figure 1.

The paths UR to TC with a coefficient of -0.001, and path UR to FP with a coefficient of -0.019, indicating negative effects. Paths RMP to TC had a coefficient 0.126, path RMP to FC had a coefficient of 0.457, and path RMP to TC had a coefficient of 0.126, while path FC to TC had a coefficient of 0.827, all indicating positive effects

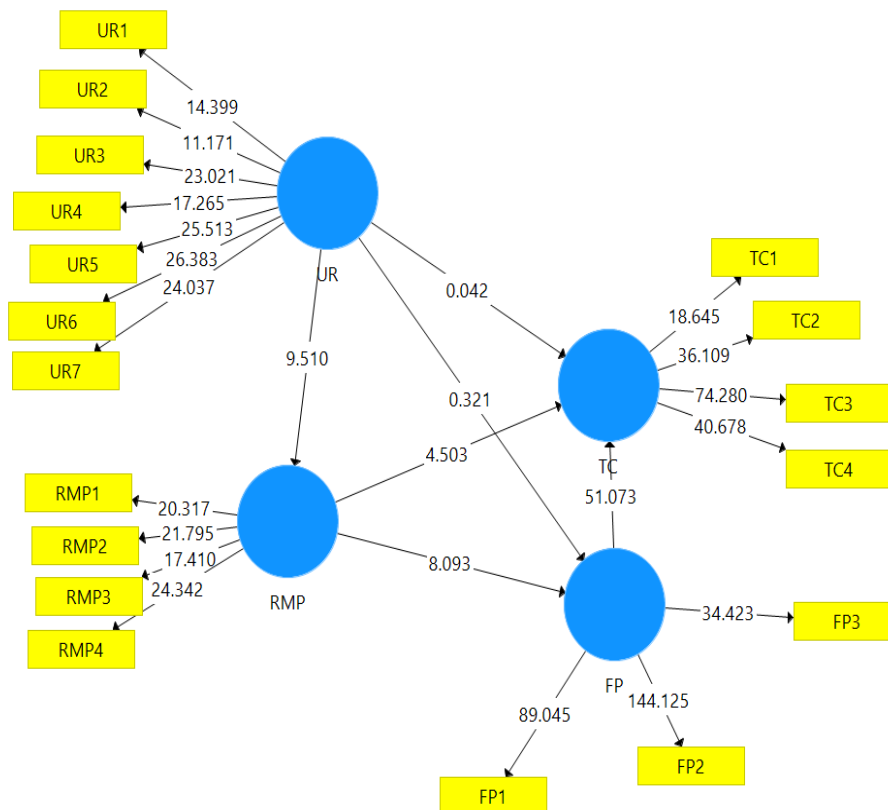
Inside the latent endogenous construct, R-square is the most effective measure of goodness of fit of a model. From table 4 below, FP had Rsquare of 0.20, while RMP, of 0.194. For endogenous variable TC; its Rsquare was 0.87 which means that the model explains 87% of the variance in tax compliance, 20% in financial performance and 19.4% in risk management practice. This presents evidence of the model in its explanatory power. The results are summarized below:

**Table 4: R-Square**

	R Square	R Square Adjusted
<b>FP</b>	0.202	0.197
<b>RMP</b>	0.194	0.191
<b>TC</b>	0.877	0.876

**4.5 Relationship Analysis and Hypothesis Testing (Structural model fit).**

The structural model analyzes path relationship and, tests hypotheses through several measures including, bootstrapping, path coefficient, and path loadings to establish a relationship between latent variables. Figure 2 below, summarizes the structural model analysis.



**Figure 2: Structural Model**

Bootstrapping is a test of verifying the significance of the path coefficients using t values which are significant at <0.005 when t values are greater than 1.96. The bootstrapping results were presented in Table 5

**Table 5:** PLS Bootstrap Output

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T.Statistics ( O/STDEV )	P Values	Results
<b>FP -&gt; TC</b>	0.873	0.872	0.017	51.073	0.000	Supported
<b>RMP -&gt; FP</b>	0.457	0.459	0.056	8.093	0.000	Supported
<b>RMP -&gt; TC</b>	0.126	0.128	0.028	4.503	0.000	Supported
<b>UR -&gt; FP</b>	-0.019	-0.013	0.058	0.321	0.748	Rejected
<b>UR -&gt; RMP</b>	0.440	0.445	0.046	9.510	0.000	Supported
<b>UR -&gt; TC</b>	-0.001	-0.001	0.018	0.042	0.966	Rejected

The bootstrapped significance output results in Table 5 and figure 2 above indicate that path FP to TC is significant at  $p < 0.00$  with a T statistics of 51.073 which is above 1.96. Path RMP to FP is significant at  $p < 0.00$ , T statistics of 8.09. Path RMP to TC is also significant  $p < 0.000$  with T statistics of 4.50, Path UR to RMP is also significant at  $P < 0.000$  with the T value of 9.510, all indicating a positive relationship. Paths UR to FP and UR to TC are not significant, with  $p < 0.748$  T statistics of 321 and  $p < 0.966$  T statistics of 0.042 respectively.

## 4.6 Discussion of Verified Hypotheses

### 4.6.1 Risk Management Practices and Tax Compliance

Results indicate that there was a significant relationship between risk management practices and tax compliance supporting H: 1, Risk management practices has a strong and significant relationship with tax compliance  $p < .000$ , t statistics of 4.50. In the context of Malawi, these results imply that when risk management practices were being practiced by SMEs and are strong, the SMEs willingness to comply with taxes will also increase as managing a business includes managing taxes as well (Gwangwana 2012). SMEs will only appreciate risk for its impact on the business and the financial performance (OECD 2014). However, appreciating risk makes it imperative for them to implement risk management practices and get better financial performance out of which taxes compliance would be derived.

### 4.6.2 Risk Management Practices and Financial Performance

The results show that there is a positive effect between risk management practices and SMEs financial performance which is significant at  $p < 0.00$ , t statistic of 8.09, supporting H: 2, meaning that when SMEs manage their business risks, their business is financially stable (Njeru 2013).

This is in agreement with a study by Cormican, (2014), which also concluded that the risk management practices have a strong and significant relationship with financial performance. Failure by SMEs to manage their businesses regarding risks, would affect their income; which inversely has proven to have an impact on compliance as per the study by Young (1994), (Ritsema 2003)

### 4.6.3 Understanding Risks and Risk Management Practices

The study established a strong effect between understanding risks and risk management practices ( $p < 0.000$ ), with t statistics of 9.51, supporting H:3 which predicted that understanding risks affects risk management practices. These findings, supports a study by Marcellino & Sadabaetal (2014), and Miller (1992), which established that risk management is mainly practiced by those in the know how. Understanding business risks might increase the will to manage them, as the level of staff knowledge on risk influences efficiency and ability in risk identification process (Bruns & Fletcher, 2008, Ellegaard, 2008). Tax administration must be challenged to civic educate SMEs on risk management so that tax revenue is not at risk, which increases compliance costs. If taxpayers understand risks, they can be able to manage and control them as unmanaged risks impact on tax compliance through tax avoidance and evasion since businesses try to find a buffer for would be sales.

### 4.6.4 Understanding Risk and Tax Compliance

Path analysis results indicate that UR to TC has a negative coefficient -0.01;  $t = 0.042$ ,  $p < 0.966$ ), rejecting the hypothesis 4, that understanding risks has an impact on tax compliance. These findings contradicts with the study done



by Gwangwawa et al., (2012), where it established that understanding risks and amount spent on risk management has a positive effect on taxpayer's financial performance which indirectly impacts on tax compliance behaviors. Indirect output results from PLS SEM indicate that if understanding risk is mediated through risk management practices to tax compliance, this relationship would be significant. This therefore means that, Tax administration must endeavor to civic educate SMEs on risks and risk management practices for improved SME output.

#### **4.6.5 Understanding Risks and Financial Performance**

The research has established that there is a negative relationship between understanding risks and financial performance with a t statistic of 0.32,  $p < 0.748$ ), rejecting H: 5, meaning understanding risks do not predict financial performance. Awareness and understanding of what contributes to the success of a business are very important, SMEs must understand and manage their financial performance so that they are aware of the business status, and their action plans in case they are faced with risks, (Ozgulbas & Koyuncil, 2012). Through analysis of indirect path analysis of UR to RMP FP, it was noted that understanding risks has a positive effect on financial performance only if the risks are managed. Unmanaged risks increase compliance costs which have an impact on business income, moreover, business income define tax payable.

#### **4.6.6 Financial Performance and Tax Compliance.**

The study established that there is a strong and positive relationship between financial performance and tax compliance with a t statistic of 54.42,  $p < 0.000$ , supporting hypothesis 6. This study is supported by willingness to pay theory (Kahneman, Knetsch & Thaler, 1990) and the ability to pay theory founded by Wagner (1883). These studies established that financial performance is influenced by optimal tax reporting which has a significance influence on tax compliance. As previously established, by this study that risk management practices have a significance influence on financial performance, given that financial performance significantly influences the willingness and ability to pay, tax administration therefore must endeavor to operate an optimal tax system to initiate optimal tax reporting.

## **5. Conclusion and Recommendation**

The study indicated that risk management Practices are centered on chief executive officers in SMEs in Malawi, this is a stumbling block for continuity, and enculturation of risk management for better SME entity financial performance, hence tax compliance. While 51% of SMEs were aware of risk management, less than 20% of sample population strongly agreed that they underwent training in risk management strategies, processes, and risk -taking. Furthermore, the study revealed that SME taxpayers (82%) identify risk from the source. As value-added tax (VAT) was noted to be the most difficult tax to file, 90% of the respondents indicated that the main business constraint is tax rates. This might indicate lack of fairness in the tax system, which would result in non-compliance. This is a red flag for tax administration. The most common response to addressing risks among the SMEs was to avoid or reduce it through insurance. The SMEs mostly benchmark their performance through the cost of sales. In assessing tax administration efficiency, 31% said it was easy to avoid paying taxes; this indicates limited trust in tax administration as literature has shown that trust in administration influences tax payments (Kilcher, 2008).

Path analysis and bootstrapping results have established a strong and significant positive relationship between understanding risks, risk management practices, financial performance and tax compliance. The model explains 87% of the variance in tax compliance, 20% in financial performance and 19.4% in risk management practice, evidencing the explanatory power of the model. This discovery of this knowledge is very critical to tax administration in, signaling a roadmap for risk mitigation if tax administration is to widen its SME tax net.

The study recommends the following:

- Tax administration must reinforce their cooperation with SMEs by engaging in knowledge sharing, training and, exchanges of information on good risk management practices.
- Sensitize SMEs on the importance of managing their business risks through different programs which might include capacity building, taxpayer education, among others. Decision makers should devise plans; strategies of action and implement the mechanism to civic educate SMEs on the importance of risk managing their business, which in turn, will affect profitability and tax compliance.
- Capacity building for SMEs in risk management. These can include creating and distributing training manuals for risk management, the formation of SME chambers to educate them on good risk management practices, periodical

workshops on risk management, and tax administration must create specialized departments focusing only on risk management of SMEs.

- The study revealed that some of the challenges and risks faced by SMEs are the lack or limited financing, market risks. Therefore, it was recommended that government should consider introducing credit guarantee schemes for loans to SMEs to enhance SME access to credit so that they boost their business. On the same issue of empowering SMEs financially, the government might also consider improving SME innovation, small-town infrastructure, and expand SME financial tools so that they can boost their business.

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