

Key Reasons Why Small Businesses Fail

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Introduction

The significant role of small business in the U.S. economy suggests that an understanding of why small businesses fail (or are successful) is crucial to the stability and health of the U.S. economy. For this discussion we will define Small Business¹ to be an enterprise that is independently owned and operated for profit² that is not dominant in its industry.

It is widely agreed that the growth of small businesses contributes greatly to the nation's economic expansion. Entrepreneurship is linked to creation of jobs, increases in productivity, and improvements of living standards, and to economic growth in the United States in general³. Small businesses help create new jobs, introduce new products and provide specialized expertise to large corporations. Small firms represent about 99 percent of employers, employ about half of the private sector workforce and are responsible for about two-thirds to three-quarters of the net new jobs⁴.

Unfortunately, according to the U.S. Small Business Administration, over 50% of small businesses fail in the first year and 95% fail within the first five years⁵. "Businesses with fewer than 20 employees have only a 37% chance of surviving four years (of business) and only a 9% chance of surviving 10 years", reports Dun & Bradstreet and of these failed businesses, only 10% of them close involuntarily due to bankruptcy and the remaining 90% close because the business was not successful, did not provide the level of income desired, or was too weak to continue⁶.

The purpose of this paper is to better understand why small businesses fail and how those causes can be avoided. At the end, a framework is presented to evaluate the existing resources and understand their influence on the factors of failure from a firm level. The intent is that this is one way that will promote adoption of necessary preventive measures and a plan of action to avoid such failures.

¹ The Office of Advocacy often defines a small firm as one with fewer than 500 employees. Industry definitions are available from SBA's Office of Size Standards (www.sba.gov/size).

² U.S. Small Business Administration, "Frequently Asked Questions," 2003.

<http://www.sba.gov/advo/stats/sbfaq.html>

³ Baumol, W.J, 1993, Entrepreneurship, management and the structure of payoffs, Cambridge. MA:MIT Press

⁴ Small Business Economic indicators, Office of Small Business Advocacy, US Small Business Administration, Washington D.C, June 2003(Available from www.sba.gov)

⁵ Small Business Economic indicators, Office of Small Business Advocacy, US Small Business Administration, Washington D.C, June 2003(Available from www.sba.gov)

⁶ "Some of the Reasons Why Business Fail and How to Avoid Them." Entrepreneur Weekly, Issue 36, 3-10-96.

What is business failure?

Some conclude that a business failure occurs only when a firm files for some form of bankruptcy protection while others contend that there are numerous forms of “organizational death,” including merger or acquisition⁷. Still others argue that failure occurs if the firm fails to meet its responsibilities to the stakeholders of the organization, including employees, suppliers, customers and owners.

From a theoretical standpoint, entrepreneurial process is defined as the set of activities through which innovations change existing combinations of factors of production. The most widely recognized sources of inspiration for an entrepreneur are market efficiencies and technological process⁸. *From this viewpoint, a business failure is the termination of an entrepreneurial initiative that has fallen short of its goals.*

Every business has a life span that is depicted by its business life cycle. A business life cycle is normally defined by four stages; Introduction, Growth, Maturity and Decline. Most business life cycles will experience a slow introduction and growth stage, a short maturity stage and a rather quick decline stage. *Some studies discuss business failures as being the last stage of an organization's life cycle*⁹.

Losses that entail one's own capital or someone else's, or any form of capital reduces the rate of business continuance¹⁰. A business that is not earning an adequate return (or is not meeting owner's objectives) may discontinue existence. Personal reasons such as retirement, illness, death of the owner or selling the business to make a profit accounted for 30% of discontinuance of businesses^{11 12}. *In the context of this paper, business failure is broadly considered as a firm's inability to exist due to loss of capital or insufficient return on investments.*

When does a business fail?

Berryman¹³ observes that a number of businesses continue to trade while earning low rate of return. When viewed from this rate-of-return perspective, a business is said to have “failed” if it meets any of the following criteria:

⁷ Watson, J, Everett, J.E,1996, “Do Small Business Have High Failure Rates” Journal of Small Business Management, Oct, 1996

⁸ Schumpeter, J.A, 1950, Capitalism, Socialism and Democracy (3rd ed.) New York: Harper & Row, Shane S, 1996, Explaining rates of variation in the Unites States: 1899-1988, Journal of Management, 22: 747-781.

⁹ Weitzel, W., and E. Jonsson (1989), "Decline in Organizations: A Literature Integration and Extension," Administrative Science Quarterly 34 (March), 91-109.

¹⁰ Cochran, A.B (1981), “Small Business Mortality Rates, A Review of the literature”, Journal of Small Business Management, 19(4), 50-59.

¹¹ Ulmer, M.J., Neilson, A., 1947, “Business Turn-over and causes of failure”, Survey of Current Business(April) 10-16

¹² Gaskill,L.R., Van Auken, H.E.,1993, “A Factor Analytic Study of the Perceived Causes of Small Business Failure”, Journal of Small Business Management 31(4) 18-31

¹³ Berryman, J.E, “Small Business Bankruptcy and Failure- A survey of the literature”, in Small Business Research, ed W.C Dunlop and W.J Sheehan(Newcastle: Institute of Industrial Economics,1982), pp 1-18.

Earnings Criterion

A firm has failed if its return on capital is significantly and consistently lower than that obtainable on similar investments.

Solvency Criterion

A firm has failed if the owner, to avoid bankruptcy or loss to creditors after such actions such as execution, foreclosure or attachment, voluntarily withdraws leaving unpaid obligations¹⁴.

Bankruptcy Criterion

A firm has failed if deemed to be legally bankrupt. Bankruptcy is normally accompanied by insolvency liquidation.

Loss cutting criterion

A firm has failed if the owner disposes of the firm or its assets with losses, in order to avoid further losses.

Why does a business fail?

Determining why most businesses fail can be a helpful identification of the eventual decline phase of a business. Small firm performance has been studied from a variety of approaches to better understand why some firms fail and why others succeed. Some researchers classify business failures as catastrophic or general lack of success. About two-thirds of those businesses that cite economic factors as a reason for failure, indicate that a lack of profits is the primary reason. Catastrophic failures also result from fire, fraud, burglary and acts of God. While no person starts a new venture preparing for failure, they can have a clear plan for success which involves actions if things do go wrong.

According to statistics¹⁵ from Dun & Bradstreet, 88.7% of all business failures are due to management mistakes. Some of the leading management mistakes that lead to business failures are: going into business for the wrong reasons; the entrepreneur gets worn-out and/or underestimated time requirements; family pressure on time and funds; pride; lack of market awareness; the entrepreneur falls in love with the product/business; lack of financial responsibility and awareness; lack of a clear focus etc. The 12 broad causes that lead to a business failure are summarized below.

¹⁴ Dun and Bradstreet, 2004 www.dnb.com

¹⁵ "Small Business: Preventing Failure - Promoting Success," Lewis A Paul, Jr., the Wichita State University, Small Business Development Center.

Lack of Industry Experience

Every business has an environment in which it operates. The internal resources of a firm must match the needs of the environment to which the firm caters. Lack of experience in the industry will lead to poor organization of a firm and its resources. The structure of the industry in which the organization operates substantially influences small firm performance outcomes¹⁶.

Inadequate Financing

Financing is the lifeblood of growing a business whether in the startup phase or in a later stage. Many businesses fail due to lack of proper financing channels. It is not a matter of unavailability of funding, but the lack of planning for funding to support opportunities for growth. Planning in advance, rather than looking for financing just when needed, is a good practice. Trouble results when entrepreneurs do not have sufficient awareness of the costs involved in raising capital, are not prepared with alternative sources in case of rejection from financiers, fail to consider using a combination of debt and equity to fund the business or, in general, fail to plan for growing their business to avoid the crisis of financing.

Lack of Adequate Cash Flow

Cash flow is the measure of a firm's ability to maintain sufficient funding to meet its expenses for the day-to-day activities of the business. Many small businesses fail because owners have a difficult time projecting what cash will come in every month, and thus, how much can go out. It is vitally important for an entrepreneur to learn some basic accounting disciplines and be able to make cash flow projections that will help them understand how much they can afford to spend every month.

Poor Business Planning

Nine out of ten business failures in the United States are caused by a lack of general business management skills and planning¹⁷. A good business plan helps identify the mission; cost structure; market; external influences; and strengths and weakness of a business. The business plan can separately include a marketing plan, operating plan, etc.

Management Incompetence

Ninety percent of business failures are associated with "management inadequacy", which consist of either management inexperience or incompetence¹⁸. Good management efficiently implements and monitors the strategic and operational plan of a business.

¹⁶ Keats, B.W., and J.S. Bracker (1988), "Toward a Theory of Small Firm Performance: A Conceptual Model," *American Journal of Small Business* 12 (Summer), 41-58.

¹⁷ Small Business Development Center, Troy State University, Troy, Alabama.

¹⁸ Perry, C and Pendleton, W, *Successful Small Business Management* (Sydney: Pitman Publishing, 1983), p 13.

A good strategic plan is only good as the management's ability to implement changes in day to day operations

Ignoring the Competition

Capitalism is a cutthroat system. Customers are always looking for the best deal, or at least, a better deal. And if the competition offers better products, services, or prices, the customers will succeed at the expense of the business. Keeping an eye on competitors and positioning the products accordingly is vital to staying in business.

Unworkable Goals

It is one thing to set goals and another thing to set workable goals. Entrepreneurial initiatives are fundamentally influenced by uncertainty¹⁹. Setting realistic goals, within the bounds of acceptable risk taking and optimism, is important.

Diminished Customer Base

Competition can cause the customer base to diminish. From a small business's perspective, it is good to focus on a customer strategy that works well for their business. At the same time it is also dangerous to focus only on one recipe for success. Diversifying the customer base is an important factor in building the business. Being flexible enough to adapt to new trends and ideas is important to staying in business.

Uncontrolled Growth

Uncontrolled growth of the business can also cause it to fail if not handled appropriately. Obesity is a problem in business as it is in an individual's health. Proper planning must be in place even for business growth. Successful growth requires a professional management team, flexible organization, and proper systems and controls.

Inappropriate Location

The old real estate maxim — location, location, location — may be even truer in the small business world. Even the best-run retail establishment will have a difficult time succeeding if it is in a poor location. Location may not be applicable to all types of businesses, but when it is, it may be critically important.

Poor System of Control

While setting proper goals to manage the business, a system of controls is also needed to measure performance. Checks and metrics help owners manage organizational activities.

¹⁹ McGrath, R.G., 1999, Falling forward: Real options reasoning and entrepreneurial failure, Academy of Management Review, 1999, Vol. 24. No. 1,13-30

A firm cannot control the external factors affecting its environment such as customers and competitors but it can adapt its internal organizational activities. A lack of proper control on internal activities can eventually lead to business failure. Controls can be implemented in several aspects of the business. Controls can be set in place to measure the quality and quantity of production. Certain financial controls are needed to measure the overall financial performance of the business. A good control system will establish standards, measure performance, compare performance against standards and then provide for a way to correct procedures where needed.

Lack of Entrepreneurial Skills

Mostly during the startup phase of a new business, lack of entrepreneurial skills in an owner can cause a business to fail. This may not be true during the later growth and maturity periods of business where more administrative and management skills are required. A small firm's performance outcome is a function of many variables, including individual owner characteristics, owner behaviors, and environmental influences¹⁵. Entrepreneurs generally have a high need for achievement and social awareness, and they are high risk takers²⁰. Consequently, the personal and personality characteristics of an owner can be a cause of business failure.

Resource analysis of a small business firm

A pragmatic approach to identifying and dealing with factors that cause failure in a small business is outlined in this section. This is only one of a variety of different tools that can be used for assessing a firm's vulnerability to failure. It is presented as an example of the type of assessment that can be done to evaluate the ability of a firm to sustain itself. In this example, an analysis of existing resources of a firm is used as the starting point. The suggested framework provides a balanced view of the strengths and weakness of the firm in order to build on its strengths and reduce the risks of its weaknesses.

A firm exists to provide products and services for its customers. A firm also exists because of its unique resources to produce such products and services. The optimal resource profile for a firm needs to be identified based on the product-market activities occurring in a firm. The term "resource" is conceived broadly as "anything that can be thought of as a strength or a weakness" of the firm²¹.

'Resources approach' of the firm

The theoretical background for resource analysis is based on the 'resources approach' of firms. This framework helps to identify the existing resources in a particular firm and to evaluate the factors contributing to its failure or success.

²⁰ D'Amboise, G., 1992, Management theory for Small Business: Attempts and Requirements, Academy of Management Review, 1988, Vol. 13, No.2, 226-240.

²¹ Wernerfelt, Birger (1984). "A Resource-Based View of the Firm," Strategic Management Journal 5(2), 171-180.

Penrose's resource approach²² to the growth of a firm is a classical study that bridges theories of economics and management. Several research initiatives have further developed on the 'resources approach' concept. Penrose defined a firm as a "collection of physical and human resources"²³. Accordingly, firm-specific resources include all types of resources that a firm possesses such as human, technological, capital, knowledge etc.

Resources in many different combinations can provide services on behalf of the firm. Barney²⁴ provided four key attributes to define more complex resources in a firm that can yield sustainable competitive advantage: valuable; rare; imperfectly imitable; non-substitutable²⁵. Some resources can be clearly identified within a firm while others cannot be identified. Though this theoretical foundation provides a framework to identify resources, the model is not restricted to certain resources. In the model, the reader is encouraged to identify as many resources that they could possibly find within the firm subject to analysis

Categorizing firm resources

Once as many resources as possible are recognized the next step is to categorize them to better understand what factors can impact the firm. The two categories into which the firm's resources can be divided are Internal/External and Strategic/Operational. Internal/External is based on the environment in which the resources operate and Strategic/Operational is based on the impact of the resources on the business plan.

The Internal resources are mostly the firm's internal strengths to sustain its existence while the External resources affect the external environment over which a firm has no direct control such as customers, suppliers, competitors, financing institutions etc. The resources are also classified as Strategic or Operational based on their influence on the overall vision and plan of the firm. Operational efficiency impacts the day-to-day operations, while Strategic are longer term that complement the strategic plan of the firm.

The four resulting quadrants of resource classifications are arrayed in figure 1. The resources identified in each of the quadrants may overlap with each other.

²² Penrose, E.T., 1959, *The theory of the growth of the firm*, New York, John Wiley.

²³ *The Theory of the growth of the firm*, Page 9.

²⁴ Barney, Jay B. ,1991, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17(1), 99-120.

²⁵ The form of resources such as patents, properties, proprietary technologies, or relationships are mainly intangible resources and are likely sources of competitive advantage.

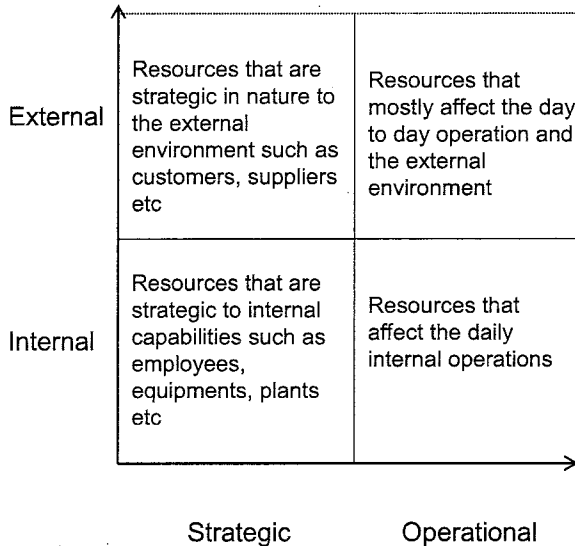


Figure 1.A Framework for identifying resources that affect business failure

Identify the preventive measures in each area

Once the resources of the firm are categorized in the respective quadrants, the potential causes of failure described in the previous section can be compared to the firm's strengths and weaknesses. Resources that closely correlate with potential causes of failure are derived from the four quadrant analysis and used as a basis for framing preventive measures. Some resources are affected more, while others are affected less. The resource analysis helps better understand each of the resources affected, so that the respective preventive measures can be outlined.

Set the order of priority and plan of action for resolution.

The identified preventive measures are translated into a plan of action which can be implemented in the firm based on the order of priority. The framework is useful for diagnosing the areas that can cause failure. But its real value is realized only when a plan of action is prepared and implemented to work on each of the issues on an ongoing basis.

Conclusion

To address the issues that lead to business success or failure a firm has to be viewed in a broad perspective. Some of the causes are directly related to the owner/manager skills while others are more related to the environmental variables such as financials, competition, customer behavior etc.

In considering the owners/managers skills it is regrettable that in some cases the very strengths that an entrepreneur possesses may be the same ones that may lead to the failure of their enterprise. It often behooves the entrepreneur to seek out and use the council of outside advisors and experts to avoid the pitfalls that appear due to the owner/managers individual areas of management inexperience.

Preventive measures are mostly limited to what can be done on a firm level. Policy makers and firms can collectively influence the environment, but have limited ability to influence it individually. Once the causes are broadly identified, the ones that require high attention are addressed at the firm level. For a small business it is healthier (i.e. has a greater potential to succeed) to adapt to the environment in which it operates than to try to make the environment adapt to the firm's needs.

In today's competitive markets, the buzz-phrase is 'customer is king'. For a business, the reason for existing is its customers. Furthermore, the customer depends on a firm because of its resources. A careful examination of the resources that a firm possesses can enable it to evaluate opportunities and threats and act accordingly. Although this resource approach is only an example of the various methodologies that can be used to minimize the risk of failure, it does demonstrate that a firm must assess itself and act on that assessment. Under this approach, the assessment focuses on resources. Resources can be anything that helps produce, either in terms of intellectual/technological capital or properties/equipment. Some resources have long-term effect while others are useful short-term and in daily operations. Some others focus on building internal efficiencies while others strengthen a firm's relationship with its external stakeholders. All these resources, considered in a balanced approach, help reduce the risks of a firm's failure and sustain healthy growth.

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