SMALL BUSINESS FAILURES: A FRAMEWORK FOR ANALYSIS

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ABSTRACT

This article examines the myriad factors often cited as contributing to small business failure. Based upon a review of the literature addressing small business failures, three general problematic areas are identified: finance, management, and marketing. Within each of these three problematic areas, numerous specific difficulties are identified and examined. Building upon this three area framework, a diagnostic checklist is presented which may be used by a small business to identify existing, as well as potential difficulties.

INTRODUCTION

Small businesses are vital to a strong economy. As evidence, consider that in 1980 small businesses represented 9.4 of the 9.8 million total businesses in the United States. Further, small businesses annually account for approximately 40% of the U.S. gross national product (5) and 60% of the nation's work force (10).

Despite their importance, many small businesses fail each year (3). According to the Commerce Department, of every ten small businesses that are opened, seven will survive their first year, three will survive after three years, and only two will remain after five years (7). Given the desirability of improving basic understanding of and response to the problems faced by small businesses, the purposes of the present effort are the following:

1. Review the small business failure literature. 2. Identify the most problematic causes of failure. 3. Develop a self-assessment questionnaire or checklist.

LITERATURE REVIEW

The causes of small business failure have been extensively documented. While a review of the literature yields an array of pitfalls, it is both desirable and possible to reduce and group these problematic areas by function. Such a categorization is presented in Table 1. The results of this procedure indicate that finance related difficulties appear most frequently as reasons for small business failure, closely followed by managerial problems. While important, marketing related difficulties are less apparent.

Finance

Finance related issues appear to be the number one cause of small business failure with three specific sub-problems frequently contributing to small business failure.

An estimated 80% of all new business fails due to under capitalization (17). The inability to secure adequate long term financing and/or the high cost of such must be regarded as a serious problem. Furthermore, small firms typically require more frequent refinancing and are more highly leveraged, thus exacerbating the problem (4).

O'Neil and Duker (14) report small business firms that fail have an excessive debt. As a result, debt management is a time consuming and expensive task. Financial institutions charge a higher rate to the small enterprise (i.e., 2-3 points) to compensate for the greater risk (6).. O'Neil and Duker (14) suggest that small business owners spend considerable effort in debt planning and developing working relationships with financial institutions (3).

Cash flow problems also proliferate. Since cash flow represents the life blood of the organization, prolonged inadequacy of such flow lowers a firm's performance and/or leads to its demise (8). The cash flow problem often appears to be managerially based (8; 20); management simply does not realize the critical nature of cash flow.

Because management often tends to underestimate start-up and operating costs (19), cash flow becomes a problem even before the firm opens its doors. Williams (20) suggests first achieving financial stability by developing a financial plan, even if these skills must be acquired commercially. This includes pre-planning overall debt structure, operating capital and accounts receivable, as the latter area tends to be problematic for small business (11).

The ability to control costs contributes to small business failure. Excessive spending inevitably leads to financial problems, especially during periods of high inflation (9). Contributing to the cost control problem is management's fiscal irresponsibility. Management either does not exercise prudent control or ignores fiscal reality. The optimal strategy to follow in this situation may be "simply to spend smarter." This includes tightening up on routine expenditures and collection procedures while critically examining costs, purchase options, and accounting procedures (11).

Management

Managerial problems rank as the second leading cause of small business failure. Three specific managerial concerns described below appear to contribute heavily to small business failure.

Opening a small business requires the desire to be in business and the possession or ability to posses a given amount of practical skills. Unfortunately, many new owners seem to discount the value of business knowledge and/or experience. Without prior experience, training or education, the new owner is normally ill-equipped to manage a business (20).

A logical skills solution is for the prospective owner to gain experience by working for someone else in a similar business. This allows the would-be enterpriser to learn something about practices and operations before setting up shop. Other alternatives include low or no-cost counseling provided by SCORE, ACE, SBDC, SBI, and others as well as the development of managerial expertise via self-study or some type of programed learning (13).

Planning is critical for the small business (12) to insure profitable operation (14). The absence of planning may leave a business operating on a day-today basis, reducing its ability to utilize resources. Long range planning should allow the firm to anticipate and prepare for the future better. However, unclear, inadequate or nonexistent long range planning on the part of most small businesses is usually the rule rather than the exception (3).

According to Peterson and Lill (15), the keys to small business success are the development of managerial expertise and adherence to a master plan. They concluded that unprofitable firms lacked goals and clearly defined policies and objectives whereas successful firms tended to posses such direction. It is critical for a small business to prepare and adhere to a comprehensive business plan consisting of financial, managerial, and marketing components. Unfortunately, many owners and managers are not willing or do not have the time and/or expertise to create such a tool, even though assistance in preparing planning instruments is usually available at little or no cost.

Growth planning also tends to be problematic. Unplanned growth can transform a successful operation into an unsuccessful venture (18). By not having properly considered and planned for expansion, an organization is caught unprepared (financially and managerially), often leaving the firm with a critically tight cash flow (8).

Human resource management problems contribute to small business failures. A lack of qualified personnel often leaves a firm ill prepared to deal with a business' demands. Apparently, personnel costs are perceived by small business managers as being prohibitive even though the benefits offset the cost of implementing a human resource program (16).

Family members often become members of the small business firm. However, family members are assigned to positions where they do not perform effectively and represent an additional fixed cost (2). Therefore, recruiting, hiring, and retaining qualified personnel is essential for small business success (3).

Marketing

Marketing related problems also pose a serious threat to the small business. While not as conspicuous as financial problems, failure to address marketing issues will lead to business difficulties or failure. Three specific areas of difficulty have been identified.

The product line offered should occupy a position of central importance. However, this often is not the case. The failure to cultivate and offer an attractive product line is a prime problem facing the small firm. A business may be started without adequate thought given to product line consistency. This creates demand problems for the product and related services as well as the demand for related products (1).

Another product line difficulty is the failure to review product performance and mix periodically (15). Successful firms regularly evaluate and prune their product lines, eliminating lower performing products (14). This allows them to utilize their resources more effectively via the timely addition of new products (3).

Few organizations operate in a competitive vacuum. Therefore, failure to consider and/or plan a new firm's competitive position may result in major problems. Management often fails to recognize with whom it is competing or simply proceeds on the assumption that it has no competition, or competitiveness is less intense than actually exists (3).

The importance of competitive strategy cannot be overstated. The small business owner is advised to conduct a competitive audit, frequently, if not perpetually, to determine consumer perceptions of his/her business viv-a-vis competition.

Product and/or competition problems may result from inadequate market information. Because many small business owners often stake their future on their business' success, market information is critical. Indeed, market information may be more important to the small firm because of its smaller resource base (11).

Franklin and Franklin (7) recommended the periodic conduct of a market analysis. This analysis should supply information pertaining to a firm's target market which is useful in the evaluation of competition, product line, and customers (3). In addition to primary research, simply listening to customers and observing marketplace activities may prove to be invaluable sources of information.

SUMMARY AND CONCLUSIONS

Based upon the literature reviewed, financial problems, closely followed by management issues, should be of greatest concern to small businesses. Although closest to the customer, marketing problems rank third in overall failure.

Examination of specific problems indicates that cash flow difficulties and the lack of proper or adequate planning are key concerns along with human resources. Cost control failures and excessive debt burden also are major concerns.

The aforementioned problems and/or causes of small business failure are not all inclusive. The intent of this review and synthesis is to provide the small business person with a broad, yet specific, understanding of the difficulties that may be encountered. Using the proposed self-administered checklist (see Table 2), these individuals can monitor, review or examine each area to ascertain a firm's current or projected status. In doing so, it is hoped that effective and actionable plans may result.

TABLE 1 SMALL BUSINESS FAILURE LITERATURE AND SPECIFIC PROBLEM AREAS IDENTIFIED PROBLEMS Marketing Finance Management p c i d c c i r p h r o n e a o n a l u d m f d s s e p a m t p o t h t x i n a e r p d n n l t m f c e i i i a l o r g n r n t t o n i r g e e i i w t e o s o o r n w n n o c t l e h Crites (1970) * * * * Biggs (1971) * * Nekvasil (1972) * * Business Week (1975) * * Carrington & Aurelio (1976) * White (1976) * * Apostolidis (1977) * * * * * Adelsamad & Kindling (1978) * * * * * Burr & Heckman (1979) * * * Kennedy et al. (1979) * * * * * Graham (1980) * * * Judd & Lee (1981) * Nation's Business (1981) * * * * * * * Norris (1981) * * * Peterson & Lill (1981) * CPA Journal (1982) * * * * * * * * Franklin & Franklin (1982) * * * Management Review (1982) * * * Moyer (1982) * Franklin & Goodwin (1983) * * * Peterson et al. (1983) * * * SBA Report (1983) * * Dickinson et al. (1984) * * * * Rock (1984) * * Ambrose & Hafer (1985) * * * * * Rocha & Kahn (1985) * * Birley (1986) * Henz (1986) * * * * O'Neil & Duker (1986) * * * Schilit (1986) * * * * * * McLean (1987) * * Bruno & Leidecker (1988) * * * * * Covin & Selvin (1989) *

*Indicates this problem was identified in the literature referenced as a cause of and/or contributor to small business failure.

TABLE 2 IS THIS SMALL BUSINESS QUALIFIED FOR SUCCESS OR FAILURE?

Evaluation Category Weak Moderate Strong

I. FINANCE 1.Long term debt as a percent of sales: <2% 2% - 5% >5%

2.Long term interest expense as a percent of sales: >6% 3% - 6% >3%

3.Financial institutions officers attitudes are: questioning okay enthusiastic

4.Cash flow: For the next twelve months, the current ratio will be: <1.0 1.0-2.9 3.0 or more

5.Expected sales come from various sources; what percent of expected 12- month sales does management definitely know the actual sources? <50% 50%-70% >70%

6.The long range financial plan includes details of how many of these sections: debt structure, operating capital, and accounts receivable? 1 2 3

7.Inflation is expected to be at what level over the next twelve months? >9% 4%-9% <4%

8.Operating expenses vary from planned budgets by: >6% 3%-6% <3%

9.Expenditure procedures are: nonexistent general enforced

II.MANAGEMENT

10.Training of top managers is: nonexistent partial extensive

11.Prior experience of top managers is: nonexistent light heavy

12.A business plan for the firm is: nonexistent brief extensive

13.Functional preparation for growth/expansion is: nonexistent in place implemented

14.Qualifications of key personnel are: minimal adequate extensive

15.A personnel selection and training program is: nonexistent in place implemented

III MARKETING

16.Testing of the firm's product(s) is: rare infrequent routine

17.Pruning and upgrading the product line is: rare infrequent routine

18.Customers are asked for advice: rarely infrequently routinely

19.A competitive audit is conducted: rarely infrequently routinely

20.Market and analysis for information up-dating is: rare infrequent routine

IV. Analysis: A firm with more than two items circled under the Weak Potency level is in danger of failure; the same applies for more than nine items circled a the Moderate level.

*The descriptors used are illustrative and may need modification for specific occasions.

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