

Why do small businesses fail and how to minimize risk finance essay



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Abstract

It has been suggested that the impact of potential causes of small enterprise failure might be reduced if business owners got appropriate advice. This paper reports the results of a national study of small retail and service firms to determine the failure reasons of starting a business. Much of the literature indicates that success and failure of small businesses has a lot to do with preparation of the business owner. People who establish a plan for success are usually the people that have better chances of success with their small businesses. The primary audience for this paper are people who are considering starting their own business. A review of the literature was conducted to determine reasons for business failure. The paper concludes with suggestions of how might build on these efforts.

Table of Contents

Introduction

P. 4

2. 0

Hypothesis Development

P. 5

3. 0

What is business failure?

P. 5

4. 0

Literature review

5. 0

Method

5. 1

Research Design

6. 0

Statement of Results

7. 0

Analysis and Discussion

8. 0

Conclusion

9. 0.

Recommendations

10. 0

References

P.

Introduction

More and more people are considering starting their own business. By

opening a business there could be large profit to be made. However, there
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are losses may occur as well. Some people argued that starting a business in a field that they know well would not fail. Knowing if starting a business at all is what most small businesses fail to consider. According to an SBA Study done in 2005, "About 1/3 of Small Businesses fail in the first 2 years, and just over half fail within 4 years." (as cited in Shawn, 2009). These statistics are depressing for people looking to start up a new venture. Richard (2000) claimed SMEs in successful business networks can generate up to 50% more in gross revenues than firms that work in solitude. (p. 12). However, Richard (2000) concluded that the most significant reason for this high failure rate is the inability of SMEs to make adequate use of essential business and management practices. (p. 12). Abdelsamad and Kindling (1978) stated that although failures cannot be completely avoided in a free enterprise system, the failure rate could be reduced if some of its causes are recognized and preventive action is taken. (p. 24). It is important that small business owners evaluate if they are compatible with entrepreneurship in order to prevent from being part of the failure statistics.

Most of the studies on business failure have been elaborated into a predictive perspective. Those business failure prediction literatures mainly analyses statistical models that tend to determine. Moreover, the predictive literature has strong limitations and it provides few clues as to why and how business failure takes place. In fact, predictive studies propose a classification of firms in a default and credit risk management perspective without giving any concrete information about the potential causes of their failure.

With tough economic conditions, knowing the reasons business fail and how to avoid failure can increase your chances of success. The results of this study will benefit entrepreneurs to understand the factors of failure involved in new venture startup, to help entrepreneurs to balance between expectation and reality in the process of starting the businesses. The aim is to let business owners know more about preventive measures to avoid such failure and improve chances of success with good preparation and planning and insight. A brief literature review is presented in the next section, followed by the description of the sample and methodology, results and implications, and finally the summary and conclusions.

Hypothesis Development

People keen on starting a small business sometimes forget about the managerial and entrepreneurial skills necessary to run a business. According to Steiner and Solem (1988), “ key success factors in small manufacturing businesses would include an owner/manager with experience in the business or prior experience; adequate financial resources; a competitive advantage based upon customer and product specialization; and strategic planning.”(p. 5). (as cited in Linda Shonesy & Robert D. Gulbro , 1998). When going to start a successful small business, you are required to have expertise in business planning, financial management, marketing, human resources management etc. Business knowledge should be on the top of any requirements for small business success. If you don't know anything about the products, how can you sell the products to customer? You can acquire this knowledge through trial and error when starting a small business, but you will probably have to declare bankruptcy before you learn them all.

My theory is that lack of entrepreneurial skill is the main reasons of small business fail. Many people think the business would not be failed if resources provided, such as capital and manpower. Of course, financial management and business planning are also absolute necessities for being a successful entrepreneur. Certainly, you are unable to satisfy customers without these skills. In brief, the question is, however: is entrepreneurial skill the most important factor to prevent business failure?

What do we mean by “ Small Business”?

Every country has own definition of small business. Some of them defined for different business sectors or industries, while some determined by number of employees. Typically, definitions are based on the number of people employed. For example the traditional definition in Germany had a limit of 500 employees, while in Belgium for 100. In the United States, small business is defined by the number of people employed and it refers to less than 100 employees.

There are lots of different definitions of small and medium sized firms. In the recent literature, there is nevertheless a large tendency to differentiate between micro, small and medium size firms. Medium sized firms have a structure and an organization that tend to be closer to the ones of large firms and as the impact of human and psychological factors is less important in these firms than in smaller one. This research is based on the definition of small businesses adopted by the European Commission's definition (2003).

Table 1 summarizes the criteria which delineate small business.

Enterprise category

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Headcount

Turnover

or

Balance sheet total

medium-sized

< 250

â%œœ € 50 million

â%œœ € 43 million

small

< 50

â%œœ € 10 million

â%œœ € 10 million

micro

< 10

â%œœ € 2 million

â%œœ € 2 million

Table 1: Definition of Small and Medium sized Enterprises (European Commission, 2003)

Definition of Business failure

We have to consider the meaning of the business failure concept during the research. Some researchers defined their meaning of failure as bankruptcy, while some researchers defined as discontinuance of a business for any reason. The concept of business failure has been differently defined according to the context and the characteristics of the sample of firms. Business entity does not follow the rules and achieves the goals set forth in their business firm, as a result, earning an adequate return and may caused discontinue existence. Business firm stops working due to retirement or businesses are sold for a profit without leaving any liabilities are not classified as a failure.

According to Bruno & Leidecker (2001), " no two experts agree on a definition of business failure. Some conclude that failure only occurs when a firm files for some form of bankruptcy. Others contend that there are numerous forms of organizational death, including bankruptcy, merger, or acquisition. Still others argue that failure occurs if the firm fails to meet its responsibilities to the stakeholders of the organization, including employees, suppliers, the community as a whole, and customers, as well as the owners." (p. 51-52). In this paper, business failure is considered as incapability of business firm to maintain due to loss of capital.

Literature review

There are many studies to better understand business failure. However, according to Gaskill, Van Auken and Manning (1993), “ there are many questions still to be resolved and warrant additional exploration...previous studies do not provide a comprehensive or unified explanation for small firm failure.”(p. 10) (as cited in Robert, 1996). Why some businesses fail and why some succeed is a matter of debate, although there are some common mistakes that can sink a business in no time. One key area that small business owners often overlook is the importance of planning. Dennis (2001) found that management skills could ensure that small and medium sized enterprises are better prepared to compete in domestic and international (p. 52). It is required to know what kinds of planning you should do before starting the small business. It includes unplanned financial management and unplanned marketing research. The results of failure are many; however, no one is concerned on it. Therefore, the research’s purpose is to discuss the significant reason of why small business failure.

Poor Business Planning

Small businesses often face variety of problems according to their size. Research indicates that poor planning is responsible for most business failures. Doug & Derek (2006) found that the single largest barrier to succession can be identified as those who do not have a succession plan.(p. 308). People work hard to turn small businesses into successful enterprises. However, they have no plan for what will be happened to their business. Cause of bankruptcy often a result of poor planning rather than economic conditions. Most of the business owners who do not have succession plan

indicated that it is too early to plan. However, Doug & Derek (2006) found that professional advisers indicated it is never too early to start planning. (p. 308). In contrast, it is a barrier to overcome if succession occurs over a short period of time. It is inadequate time for the business owner to plan and execute.

Another reason why small businesses fail is poor planning of both finances and future growth.

According to the Small Business Administration and the US Department of Commerce's statistic, "businesses that fail because their principals cannot, or do not, use financial information appropriately." (as cited in Brian, 2003). Some business owners often lack of the necessary start up funds and cannot come up with adequate financing. Business owners have to arrange adequate money on hand to cover all your financial needs of the business before starting their small business. Also, it is required to calculate how much money needs to carry out daily living expenses and how much money is required to run your business. Furthermore, some of them have no cash and expect either a bank to provide financing. They wrongly assume the banks will provide them with financing based only on their good ideas. But in most instances, the banks would not take into consideration as it reflects poorly the person's ability to manage finances if has no cash. And also, owners cannot ignore the demands of new venture. Many business owners do not know what they need to know and lack of the capital to hire experienced business advisors.

Poor Financial Management

Small business financial management is a vital aspect of growing a company. According to Mark H. Friedman, founder of Real Time Strategy, " Small-business owners live and die for cash flow." (as cited in Nancy , 2006). The most important thing is the monitoring of working capital. This includes accounts receivables, accounts payable and especially cash on hand. Once lack of adequate working capital would affects the particular business. When business is going really well with cash coming in, small business owners tend not to prepare for the next round of business. And cash flow problem occur. Cash flow is a basic measure of a firm's ability to maintain sufficient funding to pay off its current liabilities. The owner should know company's bottom line and make good decisions. They should take control of finances by coming up with a budget before purchasing or investing. In order to avoid overspending and hence invest effectively, small business owner should stabilize their cash flow. With this approach can ease a cash crunch, it also can increase the value of the business.

Most business owners raise capital from banks. However, Daniel & Richard (2005) found that early stage capital is often the most difficult to raise. (p. 64). In fact, it is difficult to raise the capital required in order to properly launch and sustain a business. It will be high cost even if the capital is available. It is crucial for a new business to maintain sufficient resources especially the capital because without proper financing, a new enterprise may find it difficult to compete with competition. The owners have to know how banks approves loan before submitting an application. Financial advisors can help in this situation.

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Lack of Entrepreneurial Skills

Most of the peoples think that all it takes to run a business is money. That is not true. You could be an excellent salesperson but lack the skills to handle the seemingly mundane day-to-day skills needed to keep a business running. Entrepreneurs won't make money if can't sell products. 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 influences. Entrepreneurs generally have a high need for achievement and social awareness, and they are high risk takers. Consequently, the personal and personality characteristics of an owner can be a cause of business failure.

5. 0 Methodology

Subjects

5. 1 Research Design

Data and Sample

Instruments

Procedure

Data Collection

6. 0 Statement of Results

7. 0 Analysis and Discussion

8. 0 Conclusion

9. 0. Recommendations