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# ANALYSIS OF THE CAUSES OF SMALL BUSINESS FAILURE

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by

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To those whom I love

I went in search of my art, often in danger of my life. I have not been ashamed to learn those things which to me have seemed useful—even from vagabond, barbers and executioners. For we know how a lover will go a long way to meet the woman that he loves. How much the more, then, will the lover of wisdom be tempted to go in search of his divine mistress—

Paracelcus

# INTRODUCTION

With the concepts of "Scientific Management" beginning to take shape with the revolutionary ideas of Fredric S. Taylor, management is becoming increasingly conscious of quantification. A qualitative approach to a problem is being replaced by a quantitative and mathematical procedure.

According to Taylor, "Scientific Management" is management based on measurement plus control. Controls can be no better than the measurements upon which they are based, and, without some kind of measurement, control is impossible. Many managements find this out the hard way--they go bankurpt.

That business with the best control of costs will survive; that with relatively poor cost control will go under. The recorded history of mankind is one of bankruptcies of nations. Nationalism has always followed the "law of the jungle," with the inevitable result that the high cost producers among nations have succumbed to the low cost producers, just as the inefficient corner grocery store has succumbed to the super-market.

The "survival of the fittest" is still ruling strong in the twentieth century, weeding out the weak, diseased and unhealthy. However, from a different viewpoint, the weak and the unhealthy are not the ones diminutive in form or structure, but the ones who have failed to keep pace with the changing era.

There have been rapid advances in the field of communication and technology, and those concerns which have not updated themselves, but adhered to methods, procedures and policies of days gone by soon put up signs of "Going out of business."

# GENERAL CONSIDERATIONS

## Why Small Business

Small business is considered primarily because any activity must start from stages of infancy: man grows from a child; huge empires and civilizations are built from small groups of people; elementary ideas and notions germinate into intricate and complex thought processes; modern giant industries of today were small business of yesterday.

Secondarily, small business is part of the American heritage. The legislators responsible for devising United States government's assistance to small business in its existing forms did not envision spending large sums with no recognisable future. Their efforts to aid, counsel and assist were aimed at preserving "free competitive enterprise." In any appraisal of the conditions prerequisite to the growth and survival of a system of private enterprise, the role of small enterprise is a strategic factor. It is natural, in thinking of American industry, to be impressed with large scale operations; but these corporate giants did not start full grown, nor can they stand alone. Large-scale industries are fed by and feed thousands of smaller suppliers and customers that link the chain from raw materials to consumers.

Collectively small business might be termed as the "biggest business" in America. They make up more than 4,500,000 of 4,700,000 businesses, employ about 30 million people, and account

for about forty percent of the total business activity. Nearly one out of every two persons employed in the United States today is either owner, manager or worker in a small business.

Virile, competitive small businesses are a safeguard against concentration of political and economic power and consequent loss of individual freedoms, including freedom of the ambitious to risk capital in a venture of their own.

Still another and major reason is the essentiality of small business concerns in times of national emergency. During World War II, for example, small businesses manufactured some 30 percent of the war production. If another war should come, the larger plants almost certainly would be among the first targets of an enemy aggressor. In that event, small plants might well have to produce an even greater share of the needs than in the past.

## Definition of Small Business

We have dealt at length with the indispensibility of the "small business" in relation to the total economy, but the inevitable question arises, "What is a small business?"

Many attempts have been made and are presently being made to define "small business" in explicit terms, but the task is not a simple one. Narrowing it down in terms of number of employees is not adequate. A steel rolling mill employing 950 workers, for example, is a 'small' firm in its industry, whereas a cheese factory with 250 employees is relatively large as

compared to other firms engaged in the same activity. Hence the Small Business Administration has set several breaking points between large and small manufacturing firms, varying with the type of industry and ranging from 250 to 1000 employees. This is in conformance with the Small Business Act of 1953. Which states a small business as one which is not dominant in its field of operation.

In classifying wholesalers as "small business", Small Business Administration uses annual sales of $5 million or less, for construction concerns $7.5 million, for retailers $1 million, and for service industries $1 million.

In "small business" management is independent and usually managers are owners. Area of operations is mainly local, though markets need not be local. This conglomeration of definitions place 95 percent of American business in the "small business" category.

# WHY BUSINESSES FAIL?

## Definition of a Business Failure

Business failures are the result of many divergent factors, but before we deal with them we should define a business failure.

A business failure is often used interchangeably with bankruptcy, but bankruptcies are those businesses wherein individuals have actually filed petitions under the Federal Bankruptcy Act. Inasmuch as bankruptcy statistics refer to individuals who are not in business as well as those who are, it is necessary to eliminate the former before the figures can make much sense. The important point is that many failing businesses do not file under the Bankruptcy Act.

Others refer to "business discontinuances" as the answer to the question, but the number of situations that can be so classified is a far from accurate gauge of conditions as reflected in the number of business failures. Business, for example, may be discontinued because of death, better opportunities elsewhere, a change in the family situation, the need to move to a different location, or simple boredom.

Hence a commercial failure is one in which a business has ceased operation following bankruptcy or assignment for the benefit of creditors, or which has ceased operation with a loss to creditors after such action as execution, foreclosure or attachment, or which has been involved in court actions such as

receivership, reorganization or arrangement, or which has voluntarily compromised their obligation with creditors.

It should be pointed out that the statistics developed by Dun and Bradstreet on this basis include only businesses which failed with losses to creditors. Not counted are those failures which liquidated voluntarily and paid whatever obligations were outstanding at the time they closed their doors. There is of course a great deal of such activity going on. Below the relatively stable surface of a business population of about 4.2 million firms, some 350,000 to 400,000 discontinue business every year, only to be replaced by an equal or larger number.

## External and Internal Factors

In a study which purports to analyze causes of business mortality, one must mention that a business failure reflects conditions internal and external to the firm. The external factors are usually unmanageable by management. They include policies of government and natural calamities like wars, fire and floods. It is the internal factors that this report is primarily concerned with. The variables involved are manipulable by management, and only those businesses survive wherein those manipulating the variables are thoroughly conversant with them.

Business failures are caused by incompetence in one form or another: inexperience, lack of working capital, the increased intensity of competition, changes in the technique of production and distribution, changes in styles, fads and habits, the intro-

duction of substitute products, overtrading and undertrading, the personal extravagance of officers or partners and general inability.

The cause, more than any one other single factor, has been considered by many diligent students to be "lack of working capital". This cause has been singled out, emphasized and delicately played upon in contrast to many other causes, including incompetence, mental inertia and inexperience on the part of those guiding a business enterprise.

A few examples will indicate that the finest plant, the most meritorious product, the greatest potential market are liabilities under a poor management and that the multitude of collateral factors is not fundamentally responsible for the success or failure of a business enterprise. Other factors help or retard progress in a competitive economy, but they are in truth on a secondary plane.

If a business enterprise began operation, for example, on a net working capital of $20,000 when a minimum of $50,000 was essential at a particular location, was not the very organization of that concern with insufficient working capital the result of incompetence, inexperience, and poor management and a lack of financial knowledge regarding the minimum of working capital needed to start operation with a reasonable expectation of success?

On the other hand, if the business began operation with a net working capital of $50,000, and in three years losses reduced

the excess current assets to $20,000, were not the losses fundamentally the result of inefficient or incapable management somewhere along the line? The lack of working capital in either instance was but an outward expression of the inexperience or the inability of those in charge of the welfare of the particular business concern. It was not, in itself, the cause of the financial collapse of the enterprise.

Failures are often said to be due to the increasing intensity of competition. With hundreds of thousands more concerns in business today than ever before, we are in for a period of bigger and better competition, and that is as it should be. If the effects of competition are actually beyond the control of business management, fatalism would need to be the philosophy of business operation. The expenditure of thought energy and conscious energy would be largely superfluous.

Just consider the matter of "extreme competition" for a moment. Suppose there were 59 motion-picture theatre supply houses in the United States, and that each dealer handled a wide variety of supplies for the typical motion-picture theatre, projection machine, seats, curtains, carpets, sets, projector repair parts, lamps, accessories and carbon. Suppose competition became keener and keener, and prices were cut, first on one product--carbon--and then on others--projector repair parts, lamps, accessories, etc. Profits turned into losses as the gross margin on carbon was cut from 30 percent to 10 percent, and the gross margin on other important items were also materially

reduced. First one concern and then another would liquidate its affairs, pay the wages of its employees, its rent, and other bills, pull down the shades and close. Finally 39 remain. The question is how and what happened? Why were not the entire 59 concerns forced to liquidate under a condition of "extreme competition"? Why only 20?

Obviously the 20 which felt the results of keener competition were the marginal concerns. The management of the liquidated concerns had lacked the aggressiveness to hold old businesses and had failed to acquire new businesses on more profitable collateral ties such as air conditioning and sound equipment which could have been sold to the schools and churches.

The weaker financial business often becomes stronger and finally works into a healthy shape under the stress of intense competition because that very stress often frees aggressiveness and a will to go after and acquire sales on a profitable basis. This country is on the brink of entering a period of competition the like of which has never been seen before. Managements with the greatest ingenuity, keenness and foresight will survive and those which lack the competitive instinct, the will to work, and ability to create a hard, high-functioning organization will be the first to succumb.

Only where the management is incompetent does a concern go under. So is not a business failure which is said to result from intense competition generally caused by poor or misguided management where inertia has finally played its last leading

role?

Perhaps the financial condition of the concern liquidated was not strong enough to stand up against the strain as long as the others. Then that financial condition again had been brought about by mistakes in policies, by lethargy, by unskilled management guidance. If a particular business is started with too little funds, that again can be laid only at the doors of the owners; and if it becomes weak financially as a result of operating losses, the management again must accept the responsibility. Even failures which are said to be the result of such factors as changes in styles, fads and habits may be laid no where except at the doorstep of the executive staff. There is no one policy to which the real executive gives more serious study and attention than just such changes. An agressive and wide awake management generally realizes that changes are taking place behind the scenes many months, and at times years, before they come to light. Consequently, improvement and changes are made in the product well in advance of actual need.

Less alert executive staffs would have watched their sales shrink to the vanishing point and then, when it was too late, would have placed the onus on the changing times. Every manufacturing or wholesaling business enterprise, and most of the larger retailers which have been in existence 25 years or more, has had to meet and overcome changes in the demands of customers, in manufacturing processes and in the methods of distribution.

A constant change is in process, a change which is quietly taking place in the method of operation of all concerns whose

management have a firm grasp on reality.

This discussion of the causes of business failures indicates that most of these causes, whether they are said to be beyond the control of management or not, are largely attributable to management in one form or another. With this emphasis on the extreme importance of the knowledge, skill, experience, and aggressiveness of operating management, the principal causes of failure fall under two basic classifications: those which are manifestations of managerial ineptitude, and those occasional instances in which the skill of the management plays little or no part.

Every policy and decision of an executive staff has its reflection somewhere in the assets and liabilities of the balance sheet, the surplus account, or in the profit and loss statement and consequently is disclosed by the healthy or unhealthy proportions of the various assets, liabilities and expenses of a business enterprise. The causes of business failures which are manifestations of managerial ineptitudes may be evidenced by inability to avoid conditions which result in heavy liabilities, excessive inventory, top-heavy fixed assets, excessive receivables, inadequate sales, heavy operating expenses, poor location or competitive weakness. These conditions are fundamental expressions of managerial inefficiency, mental or physical lassitude, or rash judgement.

Each of these conditions in turn may be brought to light by one or several secondary factors or symptoms such as poor business

conditions, changes in the accepted technique of production and distribution, changes in styles and habits, introduction of substitute products, inadequate budgetry and accounting controls etc.

## FAILURES BY SIZE OF LIABILITIES

In attempting to bring out the fact that it is the small businesses in the main which are susceptible to these managerial deficiencies, the liability of a failing concern is considered which is indicative of its initial and final financial status.

An insolvent concern allows debt to accumulate rapidly as resources evaporate; hence it is not unusual to see a concern's liability at the time of failure mount to the point where it exceeds the former net worth by 3-4 times.[1] A concern worth $25,000 when it was in good financial health might well owe more than $100,000 at the time of failure.

Chart I depicts a breakdown of failures by size of liabilities at the time of failure from 1934 onwards. In the 30's and 40's the percentage of failures under $5,000 category is much higher than in the range of $25,000-100,000 (the average being 30 percent and 15 percent respectively); whereas in the past decade this trend has shifted to the range of $25,000-100,000 with an average of 27 percent and with under $5,000 having an average of 12 percent. The apparent reason is that today's businessman operates under a much greater strain then his counterpart did 20-30 years ago. Advances in communication and technology in factory, store, and office have speeded up the business pace requiring considerably larger initial capital investment and factual knowledge and business know-how.

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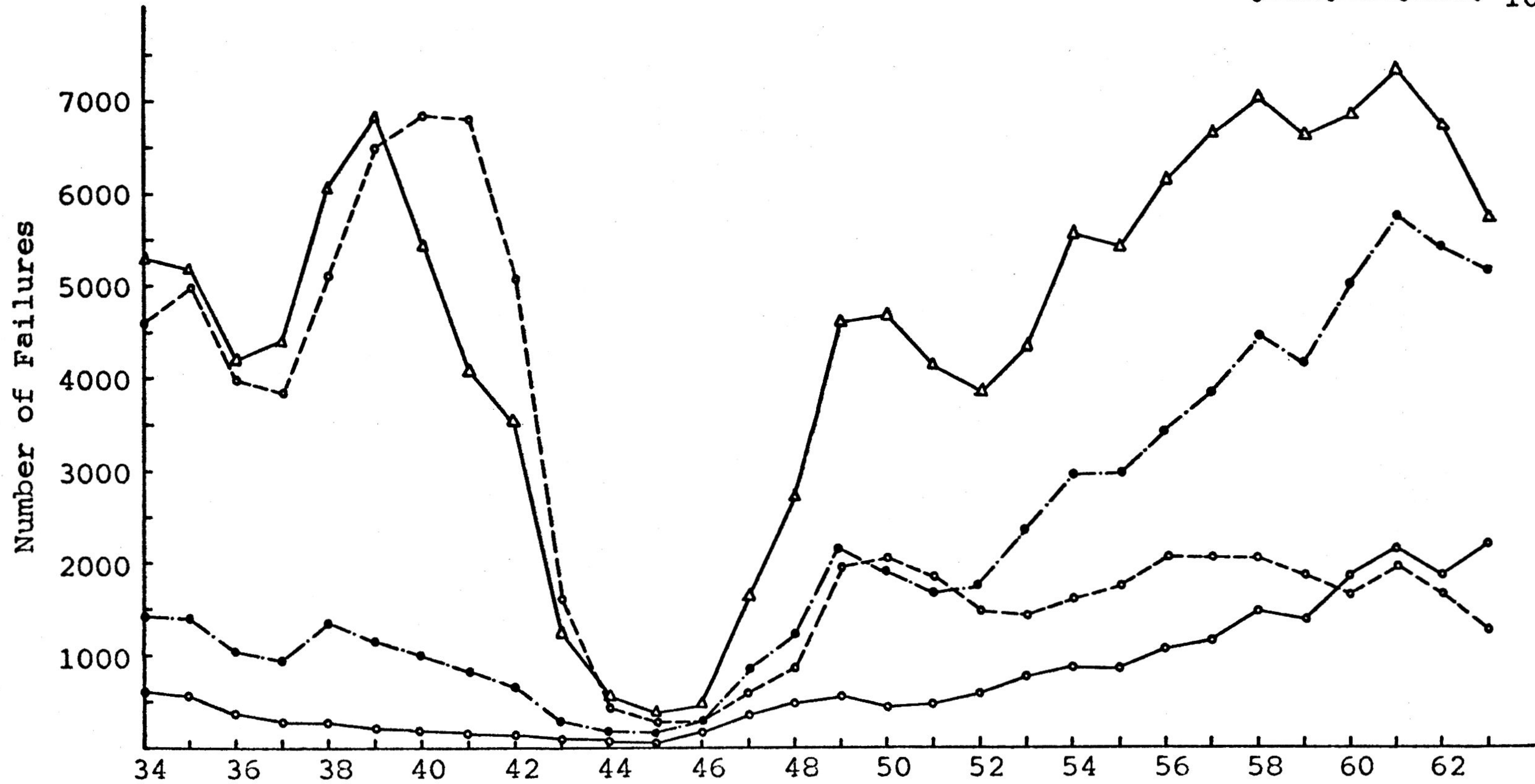
[1]Duns Review and Modern Industry, Vol. 70, pg. 46.

Distribution of Business Failures by Size of Liability, 1934-1963*

| Year | < $5000 | | 5000-25000 | | 25000-100,000 | | > 100,000 | |
|---|---|---|---|---|---|---|---|---|
| | No | % | No | % | No | % | No | % |
| 1934 | 4610 | 38.1 | 5340 | 44.2 | 1471 | 12.2 | 670 | 5.5 |
| 1935 | 4992 | 40.8 | 5278 | 43.1 | 1421 | 11.6 | 553 | 4.5 |
| 1936 | 3988 | 41.5 | 4255 | 44.3 | 1042 | 10.9 | 322 | 3.3 |
| 1937 | 3866 | 40.8 | 4349 | 45.8 | 988 | 10.4 | 287 | 3.0 |
| 1938 | 5131 | 40.0 | 6026 | 46.9 | 1396 | 10.9 | 283 | 2.2 |
| 1939 | 6522 | 44.2 | 6873 | 46.5 | 1146 | 7.8 | 227 | 1.5 |
| 1940 | 6891 | 50.6 | 5442 | 40.0 | 1067 | 7.8 | 219 | 1.6 |
| 1941 | 6754 | 57.0 | 4116 | 34.7 | 815 | 6.9 | 163 | 1.4 |
| 1942 | 5097 | 54.2 | 3525 | 37.5 | 660 | 7.0 | 123 | 1.3 |
| 1943 | 1614 | 50.1 | 1272 | 39.5 | 269 | 8.3 | 65 | 2.1 |
| 1944 | 452 | 37.0 | 549 | 44.9 | 175 | 14.3 | 46 | 3.8 |
| 1945 | 270 | 33.4 | 343 | 42.4 | 146 | 18.0 | 50 | 6.2 |
| 1946 | 263 | 23.3 | 488 | 43.2 | 252 | 22.3 | 126 | 11.2 |
| 1947 | 600 | 17.3 | 1661 | 47.8 | 842 | 24.2 | 371 | 10.7 |
| 1948 | 846 | 16.1 | 2799 | 53.3 | 1208 | 23.0 | 397 | 7.6 |
| 1949 | 1915 | 20.7 | 4646 | 50.3 | 2147 | 23.2 | 538 | 5.8 |
| 1950 | 2065 | 22.5 | 4706 | 51.4 | 1975 | 21.6 | 416 | 4.5 |
| 1951 | 1832 | 22.7 | 4160 | 51.6 | 1634 | 20.3 | 432 | 5.4 |
| 1952 | 1428 | 18.8 | 3884 | 51.0 | 1769 | 23.3 | 530 | 6.9 |
| 1953 | 1383 | 15.6 | 4317 | 48.7 | 2375 | 26.8 | 787 | 8.9 |
| 1954 | 1640 | 14.8 | 5640 | 50.9 | 2946 | 26.5 | 860 | 7.8 |
| 1955 | 1785 | 16.3 | 5412 | 49.3 | 2916 | 26.6 | 856 | 7.8 |
| 1956 | 2032 | 16.0 | 6152 | 48.4 | 3431 | 27.1 | 1071 | 8.5 |
| 1957 | 2001 | 14.6 | 6699 | 48.8 | 3847 | 28.0 | 1192 | 8.6 |
| 1958 | 2028 | 13.5 | 7015 | 46.9 | 4456 | 29.8 | 1465 | 9.8 |
| 1959 | 1841 | 13.1 | 6664 | 47.4 | 4202 | 29.9 | 1346 | 9.6 |
| 1960 | 1688 | 10.9 | 6884 | 44.6 | 5078 | 32.9 | 1795 | 11.6 |
| 1961 | 1903 | 11.1 | 7378 | 43.2 | 5725 | 33.5 | 2069 | 12.2 |
| 1962 | 1647 | 10.4 | 6700 | 42.5 | 5425 | 34.4 | 1910 | 12.7 |
| 1963 | 1296 | 9.0 | 5781 | 40.2 | 5115 | 35.6 | 2192 | 14.2 |

*Source: The Failure Record Through 1963--Dun and Bradstreet, Inc.

CHART I




LIABILITIES OVER NET WORTH OF BUSINESS FAILURES (1934-1963)

The majority of the failures are in the $5,000-25,000 range with 90 percent being under a $100,000 liability figure. But to conclude from this data that small businesses fail due to financial inaccessibility would be to ignore the main point. More than 50 percent of the failures are relatively new concerns whose primary lack is experience and business know-how. The operator of a gasoline service station does not fail primarily for want of funds. He fails because of poor location, or an overly expensive lease, or lack of mechanical aptitude, or because he does not know how to serve the public, or he is unwilling to put in the necessary hours.

It is not the unavailability of funds that will cause a bsuiness to fold, as can be seen from Chart II, wherein the growth of a concern and the sources of funds to meet the needs is shown. But these fund sources would not be forthcoming to risk the amount, if the concern exhibits utter lack of planning and managerial inability.

To be sure, if business had more capital, they would be able to withstand greater losses--and if this thesis could be extended indefinitely, there would be no need for anyone ever to give up. It is argued that, because of insufficient capital, the small operator cannot stand a set-back. If he guesses wrong on one important deal, he can be wiped out. The big business, on the other hand, can take a licking, tighten its belt and carry on. Be that as it may, it is not so much the fact that lack of funds may have caused a failure that we are considering here, as it is

the conditions that made possible such a lack to cause it.

THE 'WHERE' AND 'WHEN' OF SMALL BUSINESS BORROWING*

SOURCE OF FUNDS

Private Sources:
Personal Savings and private investors.

SBIC's become interested as firm exhibits growth potential and has need for funds exceeding amount from private source.

Investment Banks
Takes notice as company grows successfully. Need for funds $300,000.

SBA tends to relax its collateral requirements, and give consideration to the general credit of the corporation.

Commercial banks can be successfully approached for a long term loan.

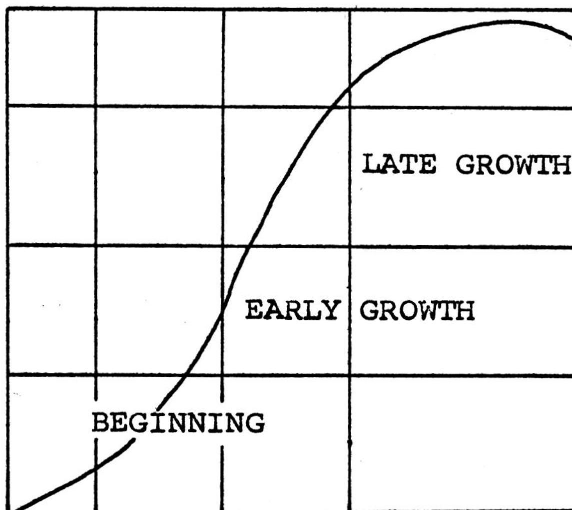
NEED FOR FUNDS

For production development, promotion, plant modernization

Company needs permanent working capital, accounts receivable and increase of inventory more rapid than accounts payable.

Additional plant and equipment required to keep production capacity up to sales level.

For product improvement, establishing channels of distribution, working capital, plant and equipment.




*Source: Denver Research Institute: University of Denver.

CHART II

FAILURES BY TYPE OF INDUSTRY

Business Failures in 1960 and 1961 *

TABLE III

| Line of Industry | 1961 | | 1960 | |
|---|---|---|---|---|
| | No. | Dollar Liabilities | No. | Liabilities |
| 1. Manufacturing | 2825 | 325,282 | 2612 | 289,635 |
| 2. Wholesale trade | 1734 | 158,465 | 1473 | 107,156 |
| 3. Retail trade | 8292 | 333,043 | 7386 | 241,094 |
| 4. Construction | 2752 | 193,005 | 2607 | 201,369 |
| 5. Commercial service | 1472 | 80,328 | 1367 | 99,376 |
| | 17,075 | | 15,445 | |

*Source: Bankers Monthly, 1962, Vol. 79.

The breakdown of failures by industries (Chart III) shows that more than fifty percent are attributed to retail trade, thus emphasizing the proneness to high mortality of small business.

Among small retailers, surveys of typical operating costs indicate that as much as ten percent of the sales income goes to support the proprietor and his family. A retailer doing an annual volume of $50,000 may draw $5,000 or so to live, and be hard put to ge below that figure in the event of sudden drop in sales. Hence the small business is less flexible than the larger company in tailoring expenses to sales.

Breakdown of Business Failures (1952-63) Industry Wise*

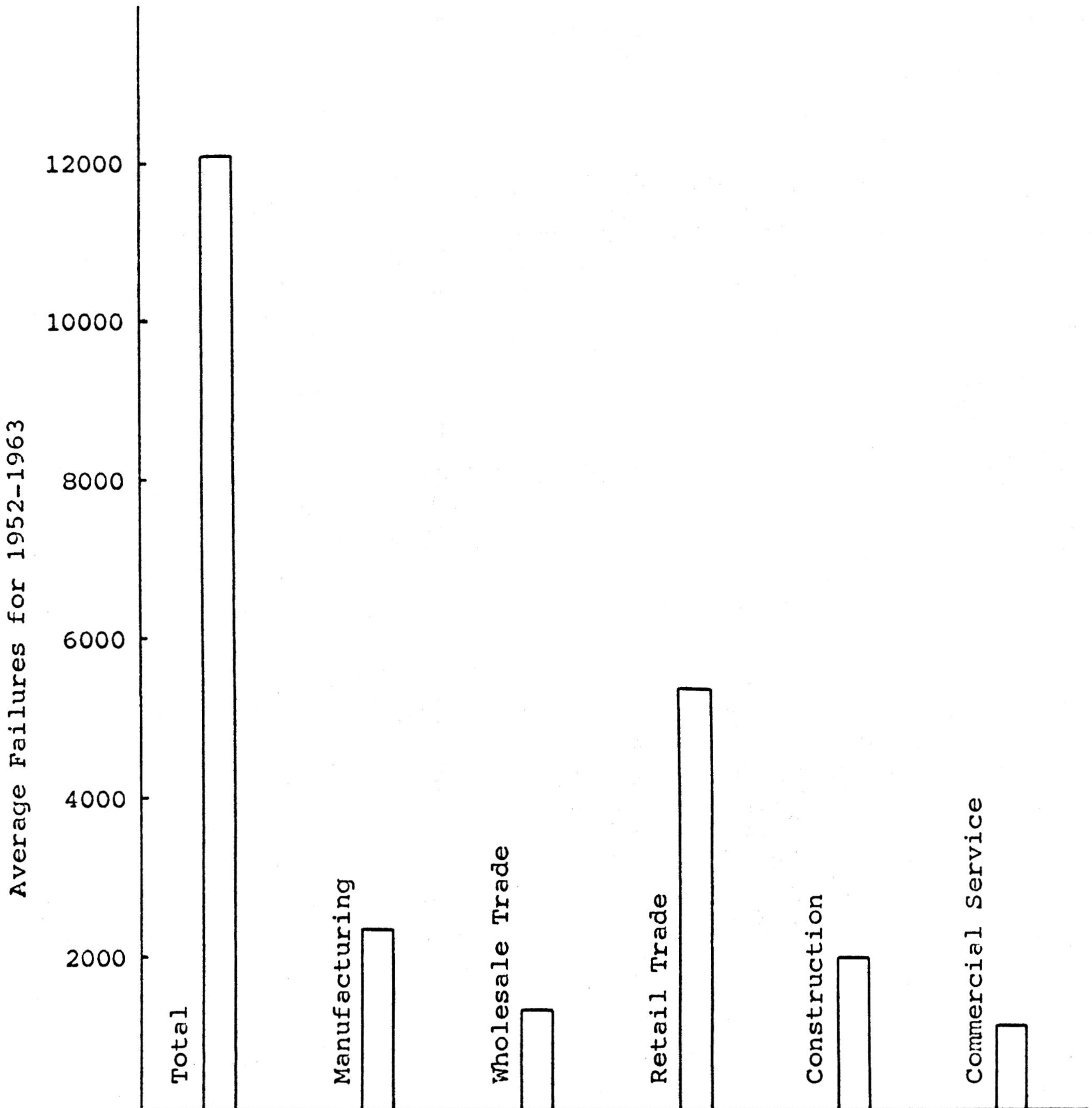
TABLE IV

| Line of Industry | Year 1952-1963 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1952 | 1953 | 1954 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 |
| Manufacturing | 1581 | 1857 | 2282 | 2202 | 2285 | 2411 | 2680 | 2465 | 2612 | 2825 | 2575 | 2409 |
| Wholesale trade | 748 | 933 | 1132 | 1164 | 1207 | 1236 | 1431 | 1387 | 1473 | 1734 | 1613 | 1510 |
| Retail trade | 3833 | 4381 | 5491 | 5339 | 6341 | 6895 | 7514 | 6873 | 7386 | 8292 | 7552 | 6681 |
| Construction | 838 | 1024 | 1305 | 1404 | 1834 | 2105 | 2162 | 2064 | 2607 | 2752 | 2703 | 2401 |
| Commercial Service | 611 | 667 | 876 | 860 | 1019 | 1092 | 1177 | 1264 | 1367 | 1472 | 1339 | 1373 |
| | 7611 | 8862 | 11086 | 10969 | 12686 | 13739 | 14964 | 14053 | 15445 | 17075 | 15782 | 14374 |

*Source: Collected from Dun's Review and Modern Industry, February Issues.

CHART III

From Table IV




TOTAL NUMBER OF BUSINESS FAILURES AND
BREAKDOWN BY INDUSTRIES (AVERAGE OF 1952-63)

## Retail Trade

An Examination of 141 failures in retail trade in one week in 1957 revealed more than 250 causes of failures. They included increased family expenses due to ill-health, starting out with too much borrowed money, heavy expenses of moving to new location, trying to grow too fast, lack of adequate financial records, underestimating cost of business, overestimating inventory requirements, losses in training new personnel, excessive advertising costs, under-insured losses from burglaries and fires, inadequate parking facilities, and keen competition.

Other than these internal factors, mention may be made of some external factors. Today we are in the throes of a revolution; suburban shopping centers compete with the downtown merchant and with other shopping centers. Parking is a new hazard. Discount houses pioneer in new methods of cutting costs, grocery chain stores are diversifying, selling unrelated items such as hosiery, work clothes and appliances. These conditions work to narrow operating margins at a time when the smaller specialized merchant is fighting rising costs.

A close parallelism is observed between business failures and automobile accidents. Some accidents occur because of bad weather, just as failures increase in bad times. Cars are getting faster and accidents occur due to excessive speed; likewise some business failures are due to a faster pace of business, and men at the helm lag behind in sterring the business on the right path. Some wrecks occur due to faulty equipment

and so do some failures.

However, the majority of the accidents can be attributed to deficiencies in the driver. His lack of knowledge of how to handle his vehicle, how to recognize his limitations and how to obey the rules of the road are mainly responsible for his ceasing to exist. Similarly the root cause of business failures is the individual business man who refuses to recognize the hazards of improper bookkeeping, improper merchandising, improper understanding of costs and inventory, poor credit practice, excessive salaries and dividends and improper financing methods.

## Manufacturing

Based on available information in the records of Dun and Bradstreet, Inc., the lack of experience factor took its toll on 94% of 2825 failures in manufacturing in 1961 (Table III). In well over half the failures, this lack of experience became apparent through inadequate sales. The second most frequent cause was competitive weakness, while a significant number failed because of receivables difficulties and excessive fixed assets.

Of the concerns failing in this category, the furniture industry recorded 289/10,000 operating businesses. Transportation equipment registered a failure rate of 231, while leather and shoe concerns had 183 failures per 10,000 concerns.

## Wholesale Trade

Inexperience again accounted for 92 percent of failures among wholesalers. This became apparent in the form of inadequate sales, receivables difficulties, etc. In about 70 percent of the cases competitive weakness and inventory difficulties took a fairly large toll.

## Construction

Many of the problems of the construction industry differ from those of manufacturing, wholesalers and retailers. Yet the underlying cause of failure in 90.3 percent of the cases cited was lack of experience. Competitive weakness was the reason for 27.7 percent of failures. Heavy operating expenses played a more dominant role in construction failures accounting for 16.6 percent of the total. Receivables difficulties, basically due to inexperience in the handling of this phase of business, took a toll of an additional 16.5 percent, while excessive investments in fixed assets was the apparent cause of 4.7 percent of the failures falling in this category.

## Commercial Service

In commercial services 90.1 percent of failures are the result of the various forms of inexperience on the part of management. It shows up in the form of inadequate sales in just over half of the reported failures. Competitive weakness is cited by 19.0 percent, while a comparatively large 12.7 percent

of the failures are due to excessive fixed assets. Heavy operating expenses and receivables difficulties together account for 13.5 percent.

## FAILING AGE OF BUSINESS CONCERNS

It is well known that in general the younger the business firm the more vulnerable it is to failure, the probability of survival increasing with age. The first few years of operating a business are usually more hazardous because that is the testing period of the ability, stamina and managerial capacities of the owner. This high susceptibility to succumb is clearly indicative of the fact, beyond a shadow of doubt, that incompetent and inexperienced individuals will be eliminated. Due to the haphazard management their resources tend to evaporate and with no renewal of funds they have no alternative but to close the doors.

In a survey in the second quarter of 1946 the results show (Chart IV) that only 2/3 lasted 1 year, only 1/2 lasted 2 years and less than 1/3 lasted as long as 5 years.

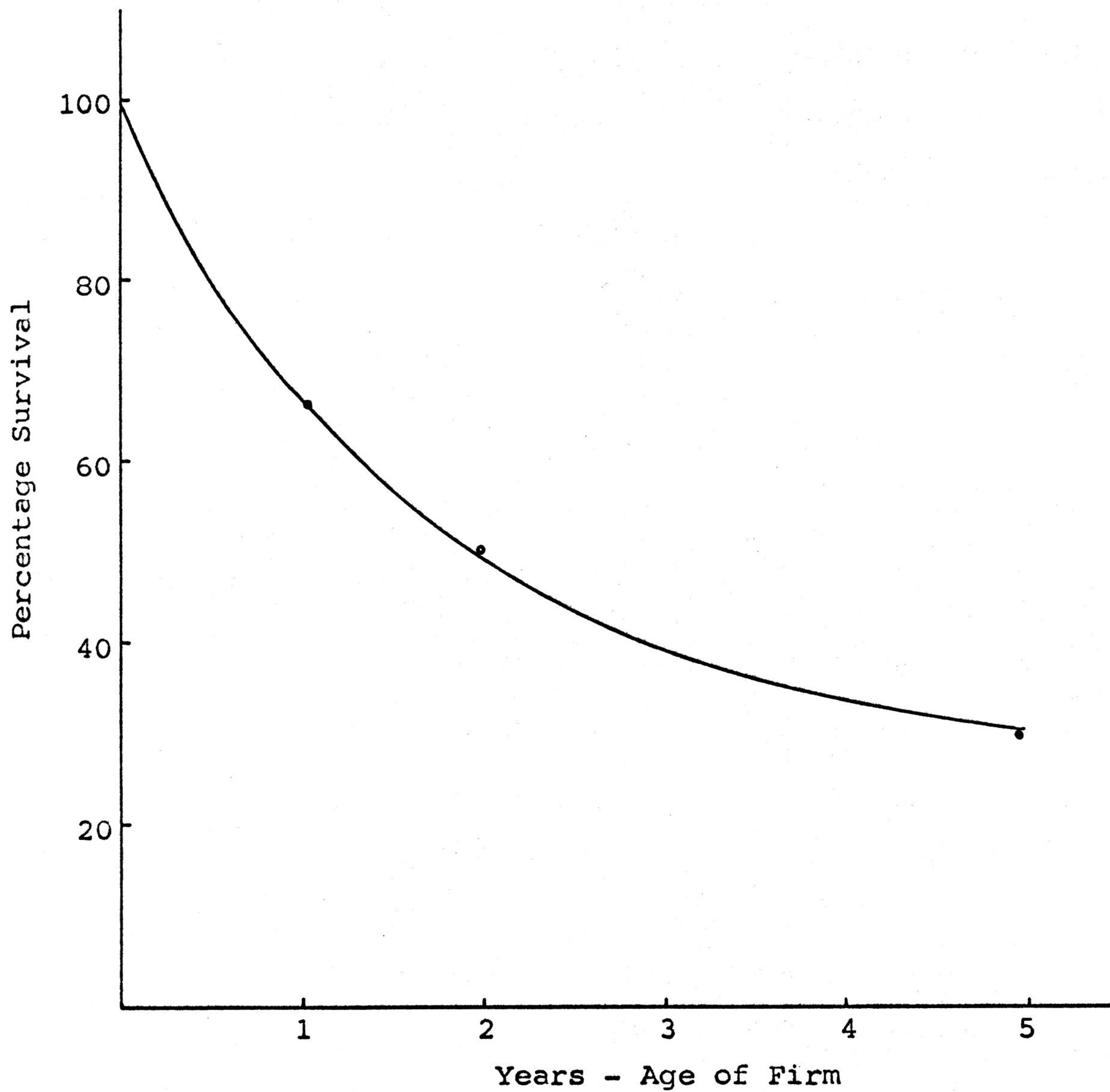
During 1950, 9162 failures occured as per Dun and Bradstreet Reference Book. Of these 4.2 percent started in business during 1950, 18.2 percent during 1949, 17.5 percent in 1948, 14.4 percent in 1947, and 13.9 percent during 1946. Only 1/5 of 1 percent started in business before 1900.

The failing age of business since 1945 onwards is shown in Chart V and Table V, which depicts the percentage of businesses in operation for less than 5 years, 6-10 years and over 10 years. The high rate of failures under 5 years of operation is suggestive of the fact that, in this period of rapid development, should there be any laxity on the part of the management to keep pace with the changing trend, the inevitable failure results.

Scientific planning and accurate forecasting of results have become imperative for the success of a concern unlike a couple of decades ago when management could easily get by with guess-work.

CHART IV

SURVEY OF SECOND QUARTER OF 1946




PERCENTAGE SURVIVAL OF BUSINESS CONCERNS IN 1946

Trend in Age of Business Failures, 1945-1963.*

TABLE V

| Year | Percent in Business | | |
|---|---|---|---|
| | < 5 years | 6-10 yrs | over 10 yrs |
| 1945 | 59.1 | 19.8 | 21.1 |
| 1946 | 71.8 | 13.9 | 14.3 |
| 1947 | 77.6 | 13.3 | 9.1 |
| 1948 | 76.5 | 12.5 | 11.0 |
| 1949 | 74.6 | 14.5 | 10.9 |
| 1950 | 65.2 | 19.0 | 12.8 |
| 1951 | 63.2 | 23.5 | 13.3 |
| 1952 | 59.9 | 25.8 | 14.3 |
| 1953 | 58.5 | 26.7 | 14.8 |
| 1954 | 57.2 | 27.3 | 15.5 |
| 1955 | 56.6 | 26.0 | 17.4 |
| 1956 | 58.6 | 23.1 | 18.3 |
| 1957 | 58.9 | 21.8 | 19.3 |
| 1958 | 57.2 | 21.4 | 21.4 |
| 1959 | 57.1 | 22.3 | 20.6 |
| 1960 | 58.6 | 20.8 | 20.6 |
| 1961 | 56.2 | 22.4 | 21.4 |
| 1962 | 55.4 | 22.2 | 22.4 |
| 1963 | 55.4 | 21.7 | 22.9 |

*Source: The Failure Record Through 1963, Dun and Bradstreet, Inc.

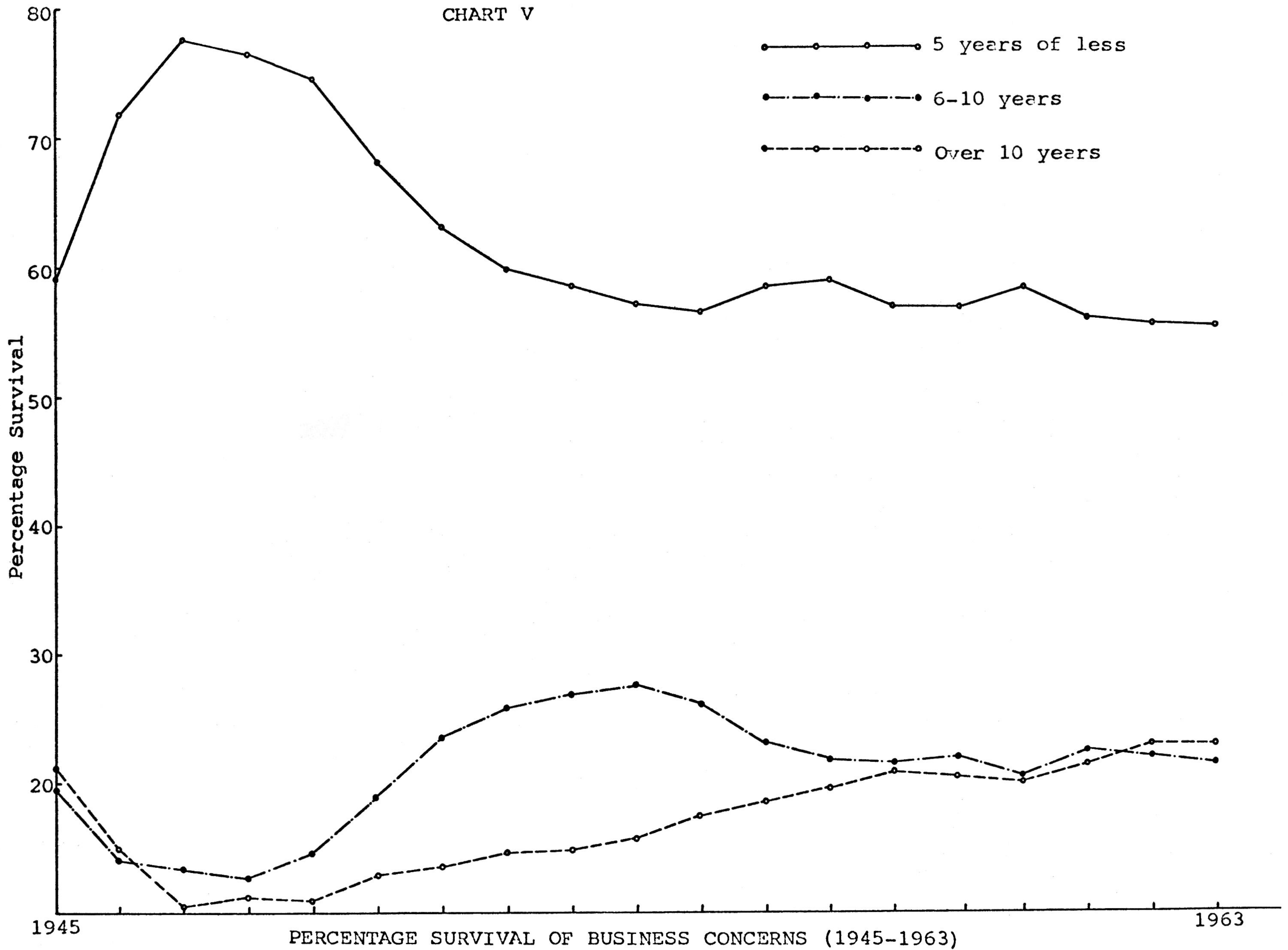



CHART V

PERCENTAGE SURVIVAL OF BUSINESS CONCERNS (1945-1963)

## CAUSES OF BUSINESS FAILURES

Since 1857 Dun and Bradstreet, Inc. has collected information of business failures with the purpose of informing credit grantors as to the frequency of failures as an element in appraising credit risks.

When a concern is reported to have failed, Dun and Bradstreet makes an investigation of the circumstances surrounding the failure. Along with the principal of the business, banks, suppliers and competitors are also interviewed in order to form an objective opinion as to the cause offailure.

The pattern which most frequently emerges from these investigations is one in which the failure can be traced directly to a clearly identifiable human weakness. It may be lack of know-how, lack of adaptibility, or lack of disciplinary qualities that make for proper financial management.

The causes, in general break down into four categories:

1. The competitive pressure of an increasing number of concerns going into business.
2. The increasing pressure of the cost price squeeze, in which all businesses find themselves.
3. Everchanging patterns in consumer demands and corollary changes in the business methods required to cope with them.
4. Lack of managerial capacity and judgement.

The high levels of sales and good times encourage many inexperienced people to start business, in the hope of learning as they go, while capitalizing on the prevailing general pros-

perity. They ignore the fact that it is the ability of the individual rather than the economic conditions that counts most in making a business operation successful.

The statistics compiled by Dun and Bradstreet, Inc. classify the causes of business failures in the following categories as being the underlying cause for a concern's demise.

Neglect

Inability of principal or principals to give full time and complete attention to the operation of the business. This condition may be due to bad habits such as drinking or gambling, to ill-health or death, to marital or family problems, or to other factors such as employment.

Fraud

Dishonest practices on the part of principal or principals such as use of a misleading name, release of a false financial statement, a premeditated overbuy or irregular disposal of assets.

Disaster

Operation of business severely disabled by fire, flood, burglary, employees fraud, strike or other.

## Inexperience

### Lack of Experience in a Particular Line

If the principal or principals had been in the present line of business for less than three years either with the subject or in a previous connection.

### Lack of Managerial Experience

If the principal or principals had less than three years of managerial experience with the subject or in a previous connection.

### Unbalanced Experience

If the principal or principals lacked experience in the operational divisions of business, such as sales, finance, purchasing or production.

## Incompetence

If all experience factors were present or the management had been in control for three years or more prior to failure, incompetence is indicated.

When inexperience or incompetence is the classification, it is frequently necessary to designate two underlying causes. Bearing on this double choice of underlying causes, are the facts that

a) declining or inadequate sales are apt to be followed by proportionately heavy operating expenses, and

b) Receivables or inventory difficulties, or excessive fixed

assets frequently result in unfavorable operating expense figures.[1]

## Excessive Liabilities

The most obvious manifestation of managerial incompetence, inexperience or neglect is the growth in liabilities of a business enterprise to a point where they have become distinctly excessive. A business becomes financially involved when its liabilities increase rapidly, when invoices cannot be paid according to terms, when interest on a funded debt cannot be met, and when the current or funded debt cannot be paid or refunded at maturity. Because these financial obligations cannot be met, a compromise settlement is reached, or a petition in bankruptcy is finally filed either by the management of a business or by its creditors.

## Managerial Incapacity

The history of all such cases would show that the liabilities had become heavy due to some one or several management decisions, or because of the lack of agressiveness or preparedness to meet competitive conditions and practices. Possibly the management in immediately preceding years had drawn excessive salaries, permitted excessive dividends or withdrawls, operated at a loss, speculated in merchandize or had onerous funded debts and excessive fixed charges. In other words along with excessive

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[1]Receivables difficulties include situations where receivables are over heavy, past due or uncollectable.

Inventory difficulties include situation where inventories are heavy, slow moving or unsalable.

liabilities there would be found underlying managerial decisions which had brought the enterprise to its final resting place.

Another manifestation of managerial incapacity is having heavy fixed assets. This condition at the same time indicates a lack of net working capital and burdens the operating account with more than its normal share of yearly depreciation. Such a condition in a manufacturing enterprise results from the desire of the management to expand the capacity and the facilities of the concern generally during a period of good business, when the business cycle turns, the concern is distressed by idle plant capacity. Such a situation is doubly dangerous when new construction and additions to plant capacity are financed with borrowed funds.

The same situation occurs with retail establishments when large sums are spent to improve the front or the inside furnishments of a store, when an addition is made to an old store, and when new units are taken over either by purchase or lease. This condition may also be brought about by the management which at an earlier date had maintained a satisfactory relationship between fixed assets and tangible net worth.

## Excessive Inventories

Managerial incompetence is found in excessive inventories. This condition may be brought about by the manufacturing or distribution of too many products or lines for the size of the business; by speculation in merchandise, i.e., by buying heavily

in anticipation of a rise in prices which often fail to materialize; by poor judgment of future markets, i.e., overbuying; by the production or handling of a product which is off-style or not in public demand; by unknowingly having prices which are competitively high; and by failure to keep the stocks neat and up-to-date.

An executive who would speculate in merchandise, who would purchase heavily in excess of his reasonable needs and whose business would subsequently become bankrupt in the ensuing drop in wholesale prices would certainly lack both knowledge and foresight. The drop in wholesale prices would not have been the cause of the failure, but merely the means through which the inexperience of the management became evident. The fundamental error was in deciding to pile up a heavy inventory far in excess of reasonable needs.

Table VI gives the percentage breakdown of the causes of failures in 1963. The majority of failures are in the inexperienced category which is evidenced by the high percentage in lack of experience in the line, lack of managerial experience, unbalanced experience and incompetence. These four factors sum to a total of over 90 percent of the total failures.

Considering the underlying causes of business failures indicated in Table VI brings to the mind a statement made by William J. Riley in the beginning of his book--The law of intellegent action, that, "It is commonly recognized and accepted that brain power is the first and most important element in the

birth, the intelligent conduct, and the successful survival of any business enterprise, more important than money, material or sheer physical labor," And too, after 17 years as a referee in bankruptcy in Manhattan, New York, Irwin Kurtz in his article, "I got 'em when they are broke" in the January 21, 1950 issue of Saturday Evening Post said: "Dishonest bankrupts are an exception rather than a rule. Put in another way most bankrupts are honest but incompetent."

TABLE VI

Classification of Causes of Business Failures in 1963 Based on Opinions of Informed Creditors and Information in Dun and Bradstreet Credit Reports

| Manu-fact. | Whole-saler | Re-tail-er | Con-struc-tion | Commer-cial Service | Total Con-cerns | Underlying Causes | | Apparent Causes | Percent Manu-fact. | Percent Whole-saler | Percent Re-tail-er | Percent Con-struc-tion | Percent Commer-cial Service | Percent Total Con-cerns |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1.8 | 3.0 | 2.6 | 3.2 | 3.7 | 2.7 | Neglect | Due to | Bad Habits | 0.4 | 0.7 | 0.5 | 0.9 | 0.9 | 0.6 |
| | | | | | | | | Poor Health | 1.1 | 1.7 | 1.2 | 1.6 | 1.7 | 1.3 |
| | | | | | | | | Marital difficulties | 0.1 | 0.1 | 0.5 | 0.3 | 0.6 | 0.4 |
| | | | | | | | | Other | 0.2 | 0.5 | 0.4 | 0.4 | 0.5 | 0.4 |
| 2.1 | 3.3 | 1.6 | 1.6 | 1.2 | 1.8 | Fraud | On the | Misleading Name | 0.1 | --- | 0.1 | 0.0 | 0.1 | 0.1 |
| | | | | | | | part of | False Financial Statement | 0.2 | 0.6 | 0.4 | 0.3 | 0.1 | 0.3 |
| | | | | | | | the prin- | Premeditated Overbuy | 0.1 | 0.5 | 0.1 | 0.0 | 0.1 | 0.1 |
| | | | | | | | cipals | Irregular Disposal of Assets | 1.3 | 1.7 | 0.7 | 1.0 | 0.8 | 1.0 |
| | | | | | | | reflected by | Other | 0.4 | 0.5 | 0.3 | 0.3 | 0.1 | 0.3 |
| 6.5 | 7.5 | 11.8 | 7.2 | 8.2 | 9.4 | Lack of Experience | Evidenced | Inadequate Sales | 50.1 | 46.1 | 49.2 | 28.3 | 41.6 | 44.8 |
| | | | | | | in Line | by in- | Heavy Operating Expenses | 9.0 | 4.6 | 2.7 | 28.2 | 8.8 | 8.8 |
| 17.9 | 16.0 | 20.8 | 23.0 | 20.3 | 20.1 | Lack of Managerial | ability | Receivables Difficulties | 15.4 | 21.4 | 6.3 | 16.8 | 6.0 | 11.1 |
| | | | | | | Experience | to avoid | Inventory Difficulties | 6.3 | 12.3 | 9.8 | 1.8 | 1.5 | 7.4 |
| 19.1 | 21.2 | 18.8 | 20.5 | 18.3 | 19.3 | Unbalanced | condi- | Excessive Fixed Assets | 7.2 | 3.8 | 4.2 | 3.9 | 9.9 | 5.2 |
| | | | | | | Experience | tions | Poor Location | 1.1 | 1.8 | 7.2 | 0.7 | 3.6 | 4.2 |
| 50.8 | 46.8 | 39.9 | 39.3 | 40.3 | 42.4 | Incompetence | which re- | Competitive Weakness | 18.3 | 21.8 | 23.7 | 19.6 | 23.0 | 21.8 |
| | | | | | | | sulted in | Other | 2.9 | 3.0 | 2.5 | 3.2 | 3.9 | 2.9 |
| 0.9 | 0.7 | 0.9 | 0.3 | 0.9 | 0.8 | Disaster | Some of | Fire | 0.5 | 0.1 | 0.5 | --- | 0.3 | 0.4 |
| | | | | | | | these oc- | Flood | --- | --- | 0.0 | --- | --- | --- |
| | | | | | | | currences | Burglary | --- | 0.1 | 0.1 | 0.1 | --- | 0.1 |
| | | | | | | | could | Employees' Fraud | 0.1 | 0.1 | 0.1 | 0.2 | --- | 0.1 |
| | | | | | | | have been | Strike | 0.1 | --- | 0.1 | --- | 0.1 | --- |
| | | | | | | | provided | Other | 0.2 | 0.4 | 0.2 | --- | 0.5 | 0.2 |
| | | | | | | | against through insurance | Percent of Total Failures | 16.8 | 10.5 | 46.4 | 16.7 | 9.6 | 100 |
| 0.9 | 1.5 | 3.6 | 4.9 | 7.1 | 3.5 | Reason Unknown | | | | | | | | |
| 2409 | 1510 | 6681 | 2401 | 1373 | 14374 | Number of Failures | | | | | | | | |
| $231506 | $115941 | $44808 | $96357 | $64897 | $94100 | Average Liabilities/ Failure | | | | | | | | |

Because some failures are due to a combination of causes, the totals of these columns exceed the totals of the corresponding columns on the left.

## EXTERNAL FACTOR: WHOLESALE PRICES

One important factor external to the working of a concern is Wholesale Commodity Prices which needs to be analyzed. There are indications that fluctuations in wholesale commodity prices have a greater effect than most other factors in aggrevating an already unsound financial condition resulting from managerial incompetence.

Business failures generally decrease when wholesale prices rise and increase when wholesale prices decline. During the years from 1926-1932 when wholesale prices were drifting lower and lower, Dun's failure index[1] went up and up reaching an all time high of 154 in 1932. Then as prices went up, slowly but steadily to 1937, failures dropped lower and lower reaching 46/10,000 concerns. in that year. As the wholesale price level reacted down in 1938 and 1939, the failures crept up. Likewise during the war years as prices increased failures decreased. Finally the all-time low of failures was reached in 1945 where there were only 810 business failures for the entire year giving a figure of 4/10,000 concerns.

As prices increased following the end of the war, the index of business failures increased. These increases, however, were fairly moderate until 1948 and 1949 when the rate of failures jumped from 20 to 34. For 1949 the index of wholesale prices made its first decline since 1939. This negative correlation

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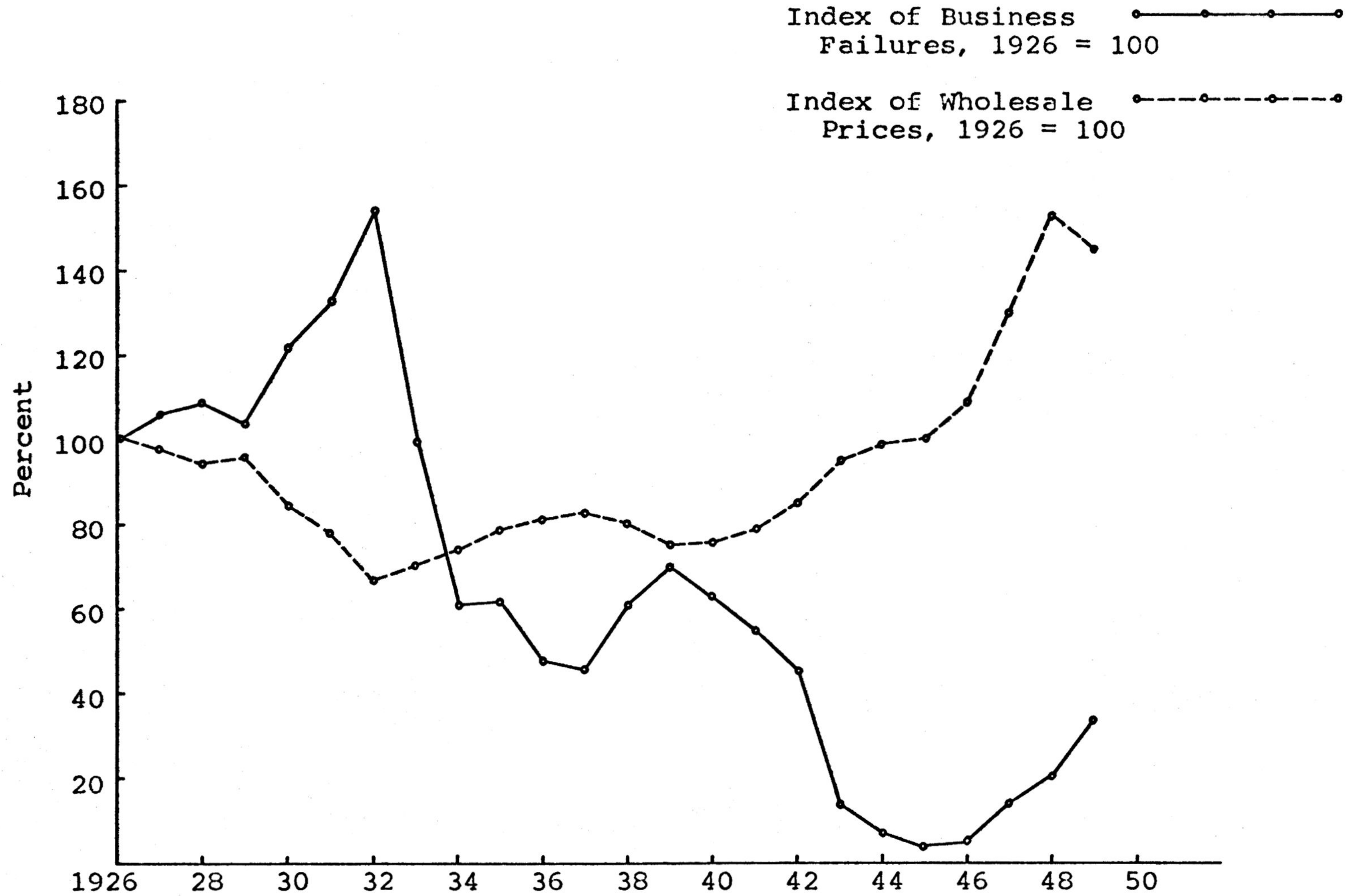
[1]Failure index: number of failures per 10,000 operating concerns as listed in Dun and Bradstreet Reference Book.

CHART VI




INDEX OF BUSINESS FAILURES AND WHOLESALE PRICES, 1926-1949

appears in Chart VI.

There are more peaks and valleys in the movement of the index of failures since its start in 1870 than in the movement of the index of wholesale prices. There is, however, some general inverse relationship between these two indexes. For specific isolated years such as 1879, 1880, 1929, 1946, 1947, 1948 they move in the same direction. On the other hand the two lowest points in the failure index occurred in 1919 and 1945 both years in which tremendous increase in purchasing media has been reflected in the upswing of wholesale prices toward two of the greatest peaks of pure inflation.

The inverse correlation which exists between the level of wholesale commodity prices and the number of yearly business failures would seem to be quite normal. A very substantial number of the approximately 2,550,000 commercial and business enterprises of the country listed in the January 1950 Reference Book of Dun and Bradstreet are marginal enterprises. They are the concerns which had been organized with insufficient capital which had taken losses for several years notwithstanding the high level of business activity which had paid excessive salaries, declared excessive withdrawls or dividends, incurred heavy liabilities, or were carrying inflated receivables or heavy inventories. Any moderate ailment will eliminate many of these marginal concerns from the field of business competition.

There is no one factor which has such an immediate effect upon the well-being of a business enterprise as the level of

prices of the raw materials which a manufacturing concern uses, or the level of wholesale prices of the products which a whole-sale or retail concern handles. If the general level of the prices of the product, which a concern handles, goes up, its own selling prices may be raised and an unexpected profit thereby obtained on the inventory purchased at lower prices and already on hand. Conversely, when the prices fall, the inventory on hand must be marked down in order that it can be sold competitively, and a loss taken in that process, a process which ends only in oblivion for many marginal concerns.

That is how the level of Wholesale Commodity Prices emphasizes the incapacities of operating managements. Businesses which are guided efficiently by skilled management, which kept liabilities, fixed assets, receivables and inventories within reasonable bounds take the rise and fall of prices in the same powerful stride. In occasional years losses are assumed, but such concerns rarely become financially distressed.

At the present time the Bureau of Labor Statistics in the Department of Labor compiles a Wholesale Price Index, weekly, monthly, and yearly designed to measure average changes in commodity prices in primary markets in U. S. From 1931 to 1937, there were 784 different commodity series used in compiling this index, from 1938-1945, from 813 to 890 different commodities and at present 860.

Separate index have been compiled monthly for 10 major commodity groups since 1890, and for 49 subgroups since 1913.

The 10 major commodity groups are the following. Food products, building material, chemicals and allied products, hides and leather products, house furnishings goods, metals and metal products, textile products, farm products, fuel and lighting and miscellaneous.

With minor exceptions, the indexes of wholesale prices and business failures move in opposite directions to each other. Since 1900 there have been three peaks in the broad cyclical fluctuations in the number of business failures, 22,156 in 1915, 23,676 in 1922, and the all time high 31,822 in 1932. Similar peaks in the failure rate per 10,000 concerns occurred in these same years, although there has been a fluctuating upward trend in the number of listed business concerns.

Since the all time low in 1945 the number and rate of failures have increased each year. Notwithstanding this steady upward trend over the past four years, the number of failures and the failure rate for 1949 were strikingly low. This fact is evident from the following comparison of the average number of failures and average rate of failures for successive decades from 1900 onwards.

The 9247 failures which occurred in 1949 were materially lower than any of the ten-year period average failure figures from 1900 to the present time with the exception of the decade 1940-1949. They were 23.3 percent lower than the average from 1900-1909, 36.5 percent lower than 1910-1919 and 55.0 percent lower than 1920-1929. Moreover the failure for 1949 were actually

34.8 percent lower than for the fifty year average of 1900-1949.

TABLE VII

Average Business Failures Per Decade (1900-49)

| Year | Average number of failures | Average failures per 10,000 |
|---|---|---|
| 1900-1909 | 12020 | 90 |
| 1910-1919 | 14530 | 90 |
| 1920-1929 | 20443 | 98 |
| 1930-1939 | 17736 | 86 |
| 1940-1949 | 5919 | 26 |
| 1900-1949 | 14130 | 78 |
| 1949 | 9247 | 34 |

A comparison of the failure rate for 1949 with the average for these earlier decades is even more impressive. The 1949 rate of 34/10,000 listed concerns was 62.3 percent lower than the average for 1900-1909, and 1910-1919, 65.3 percent lower than 1920-1929, and 56.4 percent lower than the fifty year average of 1900-1949. From 1900 through 1942 the lowest failure rate of 37/10,000 occurred in 1919, and this was somewhat higher than that of 1949.

Since 1942 there has been an economic atmosphere and environment which has been conducive to large sales, substantial profits, a high level of employment, increase in hourly wages, substantial expenditures for new plants and equipment and high

personal savings all of which were brought about by the pent up demand of the war and by rising wholesale prices.

## CASE-STUDIES

The statistics of the causes of business failures and especially the susceptibility of small business to failure compiled in the foregoing sections tend to eliminate any doubts of other possible internal factors leading to the failure of a business.

However, in any study the use of statistics makes the approach an impersonal one. To a skeptical individual it does not provide a tangible feeling except that he is dealing with a set of numbers rather than the actual situation as to what has occurred in reality. Hence to include a few case-studies would definitely prove the point, that inefficient and incapable management are the basis for the collapse of a concern, with a complete certainty.

### Analysis of Bankruptcy Records

An analysis of bankruptcy records is cited, prepared by the Geroge Washington University as a research report. The 60 cases of business failures which were analyzed from the court records represents outright financial failures of business enterprises. The cases were chosen so as to include a reasonable representation of the basic type of business activity. The sample reflects roughly the frequency with which the types of business activity were found in the court records.

Classification

| Type | Number | Percent |
|---|---|---|
| Trade | 40 | 66.7 |
| Manufacturing | 13 | 21.7 |
| Service | 7 | 11.6 |
| | 60 | 100.0 |

The numbers of different types of organization at the time of failure of the 60 firms are quite different from what they were at the times of orgin. 41 of 60 were initially established as proprietorship. 13 of these were succeeded by incorporations. 4 of them originating as partnerships were incorporated. Only 9 of 60 firms were initially established as corporations.

Among the 17 firms which changed organizations, the records examined did not reveal any evidence of insolvency of failure at the time of change. However, failure occurred within 2 years after the change for 13 of the 17 firms, with 4 remaining in business for 3 or more years after the change. While the records did not reveal that incorporation was a prelude to bankruptcy, it seems likely that incorporation may have been influenced by early signs of poor operating results.

One out of every 3 business included in the group failed in its first 2 years of operation. 3 out of 4 had failed by the end of the seventh year leaving only 1 in 4 to survive longer than 7 years. Table VIII shows the length of time in operation

for the 60 cases.

TABLE VIII

| Length of operation in months | Number | Percent |
|---|---|---|
| 12 or fewer | 13 | 21.6 |
| 13-24 | 8 | 13.3 |
| 25-36 | 4 | 6.7 |
| 37-60 | 12 | 20.0 |
| 61-84 | 8 | 13.0 |
| 85 or more | 15 | 25.0 |
| | 60 | 100.0 |

The firms were small in terms of sales volume, not over a million dollars in sales. All are believed to have been small or very small in terms of employment. 71 percent had 10 or fewer full time employees, while the largest known employment was 35 persons. It is extremely unlikely that the employment size of 12 firms where data were not available would have exceeded SBA standards.

Only 31 of the 40 Dun and Bradstreet reports provided information on prior experience of the owners. Only 5 or 12.5 percent of the owners had less than 6 years of prior experience. 13 or 32.5 percent had more than 21 years prior business experience. Quality of experience could not be determined. 11 of the owners, managers on whom credit reports were obtainable had

failed previously, 5 had failed in the same kind of business, 3 in related business and 3 in other kinds of business.

## MANAGEMENT PRACTICES OF THE CASE-STUDY

Evaluation of the management practices of the bankruptcy cases was limited by the interpretation which could be made from the court records. Almost no information comparable to the data on the problems and the use of management assistance of the group could be obtained. Information on accounting records, accounts receivable, credit and capital structure give some indication of the difficulties which the firms encountered, and of their inadequate use of available services.

No business large or small can be managed effectively without some fairly definite accounting concepts and at least a simple set of records. Those records will increase in importance as the business grows in size, but from the beginning, the relationships prevailing between income and expenses and assets and liabilities must be understood and known.

Small businesses have long been notorious for poor record-keeping, and an inadequate appreciation of good accounting practices. This situation is due in part to insufficient manpower and in part to the fact that the daily grind of managing other phases is more pressing and seems more important.

The records examined revealed evidence of poor accounting practices in all of the 60 firms. In some of them, court appointed accountants could not conduct an audit. In some check-stubs wer the only accounting record of the business. Other evidence of poor accounting practices resulting from small size or poor management practices is shown in Tables IX to XII.

TABLE IX

Persons Keeping Records in Bankruptcy Cases

| Individual keeping records | Number | Percent |
|---|---|---|
| Owner | 23 | 38.4 |
| Employee | 14 | 23.3 |
| Independent accountant | 21 | 35.0 |
| None | 2 | 3.3 |
| | 60 | 100.0 |

TABLE X

Number of Financial Statements Prepared by

Bankruptcy Cases

| Number of Statements | Number | Percent |
|---|---|---|
| None | 34 | 57.6 |
| 1 | 17 | 28.8 |
| 2 | 1 | 1.7 |
| 3 | 2 | 3.4 |
| 4 | 1 | 1.7 |
| 12 | 4 | 6.8 |
| | 59 | 100.0 |

No information available in one case.

TABLE XI

Frequency of Inventory/year by Bankurptcy Cases

| Frequency of inventory | Number | Percent |
|---|---|---|
| None | 27 | 4.5 |
| 1 | 22 | 36.7 |
| 2 | 5 | 8.3 |
| 4 | 2 | 3.3 |
| 5 or more | 4 | 6.7 |
| | 60 | 100.0 |

TABLE XII

Accounts Receivables as Percent of Total Assets for the Bankruptcy Cases

| Acts. receivables % of Total Assets | Number | Percent |
|---|---|---|
| 0 | 12 | 20.8 |
| 1-10 | 8 | 31.0 |
| 11-20 | 5 | 8.6 |
| 21-30 | 5 | 8.6 |
| 31-40 | 6 | 10.4 |
| 41-50 | 4 | 6.9 |
| 51-60 | 5 | 8.6 |
| 61-70 | 1 | 1.7 |
| 71-80 | 2 | 3.4 |
| | 58 | |

In 23 cases the owner kept his own books, more than half or 34 firms prepared no financial statements while only 4 prepared such statements monthly.

34 firms never had their books audited and only 22 firms had outside auditors. Most of the firms were in the retail and wholesale business, yet 27 never took inventories of their stock. In 18 firms the accounts receivalbe as a percent of total assets were 10 percent or less. The 12 firms showing zero receivables were retail concerns dealing strictly on cash basis.

Among the 60 firms only 8 factored or otherwise assigned accounts receivables. The firms that did assign receivables characteristically displayed a high ratio of accounts receivable to total assets. This is not true of those firms that did not assign receivables. Some had high ratios and some low. The variability of these ratios among the firms that did not assign receivables was extreme. For example, one firm had total assets of $14,440 of which $10,956 was accounts receivables; another had assets of $5,452 of which only $113 was accounts receivables.

The records indicate that there was very little supervision of accounts receivables and little control over amount of terms of credit. There was no evidence of use of collection agencies or credit investigation services. Record-keeping was slip-shod and haphazard. For example, one proprietor recorded the accounts receivable on a ruled tablet and allowed his customers to remember how much they owed him.

Information was not available to determine the percent of

bad accounts, or the age of accounts that firm had at the time of failure. However, uncollectables accounted for a large part of the accounts receivable as measured by settlement liquidation. For example, a retail furniture store listed $12,000 as accounts receivable, constituting 30 percent of total assets. These receivables were sold by the trustee in bankruptcy for $100.

Information on capital and net worth was complete on only 16 of 60 cases. All of the 16 were under capitalized. In 15 of the 16 cases, capitalization was based apparently on the cost theory with little or no regard for future needs for capital.

Analysis of the information, suggests the existence of a pattern of debt accumulation in relation to the life of the business. Among the 60 firms, in those that failed in the first year, debt began to acculululate at the outset, among those that failed by the third year, the period of debt accumulation was roughly the latter half of the life of business. In those that remained in business for five or more years, the last 2 or 3 years of operation was the period of heaviest debt.

Cash in most cases was inadequate right at the start of business. The cash position also weakened from three principal causes:

a) Indiscriminate withdrawls by management

b) Excessive inventories

c) Increasing uncollectable receivables.

Diminishing cash, declining sales, excess inventories, increasing uncollectable receivables and monthly debt accumulation

were factors for the most part ignored by management. There were some firms that were doomed from the start, but for the majority, if the danger signals had been recognized and counsel sought, failure would have, in all probability, been averted.

When these signals appeared, no action was taken to correct the situation. There was no evidence in the records examined that any owner asked for or received business advice prior to bankruptcy proceedings. There were, of course, those firms which requested help in the form of loans, but there was no indication that the requested loan constituted part of a deliberate planned action on the part of management to readjust to cope with the cause of difficulty.

A few more case studies obtained from research reports of studies conducted by University of Iowa further strengthen the hypothesis of failures due to mismanagement. These studies have two groups of firms, one out-of-business firms and one in-business firms dealing in the same line. It is easy to observe from these cases, the managerial shortcomings which led ultimately to their failure. In the cases an attempt is made to determine explicitly how management policies and practices in unsuccessful firms differed from those in successful firms of the same size and in the same economic area.

## Poultry Processing

There are two out-of-business firms and two in-business firms. Both of the out-of-business firms were partnerships. In one of these unsuccessful firms there was considerable friction among the partners. The apparent cause of this friction was that one of the partners was "a playboy" who did "almost no work" and withdrew much of the firms funds. Over a three year period, it was claimed, he outdrew the other partner by over $7,000. Ultimately the partnership was declared bankrupt and the assets of the firs were sold to satisfy creditors. One of the partners lost $17,000 and the other $15,000.

In the other poultry-processing firm which had failed, the partners attempted to borrow the money necessary to convert their plant to meet newly required government inspection standards. Approximately $65,000 was needed for this purpose. The local bank, however, refused to accept the loan because of the poor record of past earnings and even poorer earning prospects. The firm went out of business with no outstanding debt or accounts receivable. The equipment was sold, but returned only ten cents on the dollar of its original pruchase price.

The distinctive management differences between these out-of-business and the two "going concerns" may be summarized as follows:

1. Each of the firms that failed sold a large percentage of its product on credit, whereas the other did not. Both of the credit-granting firms had some credit-collection problems.

2. Whereas the two out-of-business firms processed poultry only, the apparently successful firms diversified their product line by processing eggs as a secondary product.

3. The latter firms sold their products to industrial and institutional users, as well as to individual customers, whereas the unsuccessful firms made no effort to enter this market.

4. Each of the going concerns engaged in a preventive maintenance program and lost no production through machine downtime. The out-of-business firms, on the other hand, spent large sums of money for machine repairs, and lost over 100 man-hours annually due to machine breakdowns.

5. One of the out-of-business firms purchased production materials largely on a speculative basis.

6. Neither of the out-of-business firms allocated overhead to the cost of the product, and neither used break-even analysis of costs and income.

7. Both of the out-of-business firms borrowed large amounts of long-term debt capital for use as working capital.

## Natural Cheese Industry

In this industry one in-business and one out-of-business firm was considered. The in-business firm has operated successfully for twenty-five years, whereas the out-of-business firm lasted only five years.

Both firms sold their natural cheese exclusively to wholesalers. However, the out-of-business establishment sold its

entire output on a consignment basis; thus it was necessary that the firm carry more working capital since no income was received until the wholesalers disposed of the product.

From a production point of view, the out-of-business firm had purchased a large amount of new machinery--far in excess of its current requirements. To utilize this equipment more fully, additional cream supplies were needed and this forced the management to extend cream pickups too far; the management also resorted to the use of low-grade cream. In addition, there was no adequate system of internal inspection and quality control in the plant. The result was that the quality of the firm's product deteriorated badly. On one occasion, inspectors of the Pure Food and Drug Administration found flies in the cheese produced by the firm. Sales of the firm fell to lower and lower levels.

The firm became over-extended financially and could not meet its current obligations. After its loan application to the Small Business Administration was turned down because of "insufficient planning" inadequate collateral" and "poor earning prospects", the firm was declared bankrupt and its assets were sold at public auction. Its unneeded new equipment, purchased on conditional sales contracts, was repossessed.

In contrast, the ongoing concern (of the same size) is owned and managed by a person who obviously knows his business well. He is acquainted with officials of the Kraft and Borden organizations, and has other contracts which help him considerably in

marketing his product. He finds it unnecessary to borrow debt capital, his short and long-term operations being financed from earnings and equity.

## Fluid Milk

Poor financial management is evident in the case of the single out-of-business firm as compared to three active firms. The financial records were kept very poorly. No overhead was allocated to the cost of the product, nor were break-even analyses or budgets of any kind employed. Over a period of fifteen years the owner-manager had borrowed $443,000 to meet short-term, working capital requirements. His latest attempt to borrow funds, obviously, was unsuccessful for reasons of "insufficient financial planning".

Distinct differences also exist in marketing policies and practices between this firm and the "going" concerns. Each of the latter diversified its product line through the secondary production and sale of ice cream, a product with a relatively high profit margin, whereas the unsuccessful firm relied solely on its market for fluid milk. From an advertising and sales promotion point of view, the in-business firms advertised in more media and did more in the way of sales promotion with posters, samples, booths at the trade shows etc. Whereas the out-of-business firm spent an arbitrary amount annually for sales promotion and advertising, the in-business firms spend a planned amount annually for this purpose.

## Farm Machinery and Equipment

There are two out-of-business firms and one in-business firm in this group. All of the firms are short line producers; one of the out-of-business firms manufactured a manure spreader, the second out-of-business firm produced truck hoists for farmers, and the still active firm in this industry makes a variety of farm implement attachments.

The business of all three firms was hurt by the fact that they did not produce a full line, and exclusive dealing arrangements were being formed by the larger firms that did offer a full line of farm machinery and equipment. Jobbers were sympathetic, but became less willing to handle the short-line firms' products because of pressures exerted by the larger, full-line, national-advertising manufacturers.

Both of the out-of-business firms, as well as the active firm, responded to these conditions by stressing the jobbing and repair end of their business. Only one of these three small firms, however, managed to survive.

Managerial difficulties contributing to the demise of the two out-of-business firms can be summarized as follows:

1. One of the firms did no advertising of any kind, and the second did less than the firm which is still active.
2. The non-advertising firm depended on a single key account for almost 50 percent of its sales and did not recover full cost on repair work. The large account was able to obtain significant price concessions.

3. This same firm had no minimum order policy or quantity discount schedule like the other two companies.

4. The second out-of-business firm employed no salesmen. The other two firms strengthened their own sales organizations as more and more jobbers made exclusive dealer arrangements with the larger firms.

5. The owner-manager of the second out-of-business firm also extended a considerable amount of credit on which he had difficulty collecting. (His credit sales were more than 50 percent greater than in the other firms.) He extended credit injudiciously, in an attempt to get as much business as he could.

6. Neither did the owner of the latter firm have any kind of a cost accounting system. He had no idea what his costs were on his specialty product or on job orders, and did not know how to allocate overhead costs.

7. The working capital of the second out-of-business firm was inadequate.

## SUMMARY AND CONCLUSION

That small businesses are more susceptible to failure is evident by the size of liabilities of a failing concern and the failure break-down by industry. Usually the liabilities of a concern when it goes under are 3-4 times the net-worth when the concern was in a healthy financial state.

Chart I shows maximum failures in the $5,000-25,000 and 25,000-100,000 category indicating that these firms were small businesses. Also Chart III shows that more than 50 percent are in retail trade, thus once more emphasizing the smallness of the business.

The young failing age of the concern in Chart V and the other statistics presented with the case-studies, in the report, clearly define the shortcomings as managerial deficiencies in the form of inexperience, incompetence, a lack of business acumen, and a general disregard to improving or learning or obtaining professional counsel and managerial advice.

Inexperience and incompetence being further subclassified as inadequate sales, heavy operating expenses, receivables difficulties, inventory difficulties, excessive fixed assets, poor location, competitive weakness, etc.

Ultimately the case-study evaluates the internal strengths and weaknesses of individual firms as is seen by comparing the healthy and failing concern.

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# ANALYSIS OF THE CAUSES OF SMALL BUSINESS FAILURE

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AN ABSTRACT OF A MASTER'S REPORT

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This study purports to analyze causes of small business failures with a view that survival of small business is essential to the growth of the American economy. Without small business the corporate giants have no basis on which to stand. Hence it is imperative that causes of failure of small business be minutely scrutinized and analyzed so that means may be found to rectify the shortcomings of a concern which lead to a failure.

Business failures are defined as distinct from "business discontinuances" so as to manifest the managerial lackings, rather than other influencing factors and personal gains. Essentially, factors influencing decisions by firms to go out of business must reflect internal and external business conditions with respect to the firm, and in this report, internal business conditions are given primary emphasis.

The liabilities of a failing concern are a very good indication of its initial and final financial status. Invariably when management is incapable, the assets tend to evaporate and liabilities tend to snow-ball such that liabilities at the end may be 3-4 times its initial net worth. This sometimes leads to an erroneous conclusion that lack of funds may have resulted in a failure; however, the high percentage of failures in the "inexperience" and "incompetence" category prove it otherwise.

Also the failing age of a concern, which is usually less than five years, seems to emphasize the point that managerial incapacity is essentially the reason for the early demise. The breakdown of failures by industries clearly shows that mostly

the small businesses, lacking in experience and business know-how, are more susceptible to failure.

The approach to this problem through a statistical analysis and case-study methods leave no room for doubts, and especially so when comparing the in-business and out-of-business firms, where gross violation of good management practices is clearly evident.