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Causes of failure in SMEs

The specialists in economic theory unanimously acknowledge the importance of the existence of a significant number of dynamic and profitable small and medium enterprises (SMEs). International experience demonstrates the significant role that SMEs have in promoting economic and social development.

1. The specialized literature presents a variety of opinions concerning the role of SMEs in ensuring an economic balance. Most specialists agree that SMEs represent factors of economic balance, acting in the sense of decrease of the economic concentration degree. The changes occurring on the market generate new opportunities that can be turned to good use by entrepreneurs, their action being a premise for ensuring the economic equilibrium.

2. SMEs have a higher receptivity and adaptability concerning the demands of the market, characteristics determined by their relatively small size. They offer products for limited and specific markets that are not efficient for larger enterprises, largely contributing therefore to satisfying clients' needs.

3. SMEs are more innovative in their answers to consumers' demands.

4. SMEs influence the level of the labour force employment by creating new jobs in domains undergoing significant structural changes. The cost for creating a new job in a small or medium enterprise is lower than in large enterprises.

In western countries, despite an increase in the number of SMEs, the number of employees per enterprise registers a tendency of decrease.

5. SMEs have a significant contribution to the competitive environment, thus reducing the probability that the large enterprises would control the market.

A significant number of SMEs is, however, complementary and not competitive for large enterprises to which they provide, as sub-contractors, pieces, sub-assemblies, services.

6. SMEs can ensure a combination of the productive factors that would be inefficient for large enterprises.

7. Given their great adaptability, SMEs have a special role in buffering the general shocks generated by the economic crises, given the lower volume of investments necessary in order to change their specialization.

8. SMEs ensure a greater labour satisfaction both for their entrepreneur and for their employees. Thanks to the generally harmonious work environment, labour quality is generally higher.

9. SMEs represent active agents in the creation of the new civil society, positively influencing political and social stability.

10. In transition economies, SMEs represent a decisive formation factor for the middle class.

Most specialized works concentrate on explaining the firm's success. In fact, a thorough study of the reasons of failure in SMEs could be useful not only to future entrepreneurs but also to present managers. The entrepreneur generally learns more from his failures than from his successes. But the main difficulty in this approach lays in the difficulty of spotting the firms that failed, for several reasons.

First of all, the entrepreneurs do not wish to talk about their failures, second, the cause of the failure is sometimes hard to identify by the entrepreneur, all the more as often there is no simple cause–effect relation, but a combination of several complex elements which make the understanding of the phenomenon arbitrary. For this reason, generally, there is not a single cause of the failure of new firms. There are three main causes of failure related to the couple product–market, financial situation and human resources administration (Bruno, Leidecker & Harder, 1987).

A. Causes attributed to commercial management

The insufficient diversification and knowledge of the clients (Le Marois, 1985) – source of dependence (Fourcade, 1985) is the most often quoted cause. Next comes the narrow array of products (Letowski, Cooper, 1993). These major difficulties – potential sources of failure – can be explained by two major characteristics specific to the opening period:

- The relative absence of the financial resources for financing possible market studies, both before the creation of the firm and after, not only to know the potential clients, to identify their needs and tastes, but also to check the adequacy of the offer to the market;
- The relative mastering of the savoir-faire, which will develop only gradually, as the firm develops.

B. Causes attributed to financial management

Insufficient personal financial resources (Duchesnau, Gartner, 1992) and lack of liquidities (Bradstreet, 1981) are major reasons of failure during the starting period. If the underestimation of one's financial needs is generally associated to the period of creation, the prolongation of this condition during the opening stage can be disastrous. Only by maintaining a sufficient solvability the firm can ensure its financial survival. But this flexibility cannot be reached during the opening period because the firm generally contents itself with exploiting just one product. Consequently, the first growth rhythms will be high thanks to the euphoria of the opening or to some temporary fiscal advantages. But, very rapidly, the opposite tendencies will manifest themselves: sales will stagnate, stocks will increase and the risk of not reaching the goals will increase. These specific opening costs are called "hidden costs": it is hard for the fresh entrepreneur to foresee them, as he does not have any knowledge of financial management. At the opposite pole, the entrepreneur thirsting for security will try to minimize the level of his hidden resources by looking for fiscal advantages, requiring discounts from his providers, contributions from one's family and friends etc.

C. Causes attributed to strategic management

Too fast growth (Hambrick, Crozier) is the most often quoted cause. According to Hambrick, dynamism and firm's stagnation are not antagonistic. This statement acquires new values in the context of the clarification of the causes of failure. Not only these two attributes are not antagonistic, but more than that, a too fast uncontrolled development increases the risk of failure in the opening stage.

D. Causes attributed to human resources management

Such causes are not very numerous in the specialized literature. This is easy to understand if we consider the fact that few newly created firms hire a large number of personnel during their first years of existence: Callies (1989) shows that 60% of the new businesses do not hire any employee during the first four years of existence. It results that the lack of team spirit (Fourcade, 1988) or of efficiency (Bruno, Leidecker, Harder, 1987) are the primary causes of failure. It can be explained by the fact that an inefficient internal communication and a too/"present" entrepreneur do not leave the employees anything but the execution tasks. Thus, their contribution and collaboration with the entrepreneur diminish until they completely disappear.

E. Causes attributed to the entrepreneur

Lack of experience (Cooper, Bruno, 1977) seems to be the major failure cause attributed to the entrepreneur. Lack of managerial competence (Massacrier, Rigaud, 1984) is an important failure factor too. All these reasons for failure mentioned above are the result of a statistic analysis, most of the quoted authors approaching, in general, a cause of the failure without examining its consequences on the other functions or departments of the firm. This proven deficiency led several researchers to try to identify some connections between the problems encountered, susceptible of turning, sooner or later, into failure causes. These authors tried to analyze the factors of failure during their entire existence and from an evolutive perspective from problem to failure.

Capiez (1990) shows the fact that some of the problems that the entrepreneur has to face during the opening period evolve in parallel (for instance, the marketing and financial problems or the financial or production-related problems).

The author notices that the firm's age is a factor of intensification of these problems (Table 1).

Table 1. Problems the firm is faced with depending on age

<table>
<tr><th rowspan="2">Firm's age</th><th rowspan="2">Problems</th><th colspan="3">Problem gravity</th></tr>
<tr><th>Very big</th><th>Medium</th><th>Low</th></tr>
<tr><td>0–6 months</td><td>General management problems</td><td></td><td>X</td><td></td></tr>
<tr><td rowspan="2">6 months–1 year</td><td>Financial and marketing problems</td><td></td><td>X</td><td></td></tr>
<tr><td>Production and human resources problems</td><td></td><td></td><td>X</td></tr>
<tr><td rowspan="2">1 year–2 years</td><td>Financial and marketing problems</td><td>X</td><td></td><td></td></tr>
<tr><td>Production and human resources problems</td><td></td><td>X</td><td></td></tr>
<tr><td>Over 2 years</td><td>Financial, marketing, production and human resources problems</td><td colspan="3">X</td></tr>
</table>

Source: Adapted from A. Capiez (1990), p. 327–344.

Thus, the firms "younger" than 6 months old are faced with general problems concerning the current management of the business, which are solved relatively rapidly. The firms aged between 6 months and 1 year-old are faced, more acutely, with financial and marketing problems; production and human resources difficulties can appear with the first hirings, but their importance is smaller. The firms aged between 1 and 2 years are faced with an aggravation of their financial and marketing problems, to which are added the production and human resources problems that were previously at an incipient stage. For the firms "older" than two-year-old, a stabilization of the problems mentioned above can be noticed.

Alpander (Alpander, Carter, Forsgreen, 1990) achieves an evolutive study of the failure generating problems, considering that they are:

- Attracting new clients;
- Obtaining financial resources;
- Hiring and forming new employees;
- Hiring and forming executive managers;

- Solving current personnel problems;
- Market enlargement planning;
- Juridical problems solving;
- Reaching and maintaining product quality;
- Negotiating with administrative authorities.

The author shows that for 70% of the situations, these problems (especially the first three categories) were felt from the very first year of activity. During the second year the problems' nature evolves and concentrates on maintaining products' quality. Finally, during the third year, the administrative and juridical problems increase.

These studies demonstrate the fact that the problems evolve during the opening period. Fourcade (1988) goes deeper into this analysis, making a hierarchy of the diverse problems according to their intensity as perceived by the entrepreneur.

General problems, that all the firms, regardless of size, have to face, namely:

- The setting up of the production factors (technical set-up);
- Searching providers (market upstream);
- Attracting clients (market downstream);
- Administrative environment (constraints concerning small firms);
- Financial environment (lack of resources).

These problems' persistence and aggravation risk to drag the firm towards a dangerous evolution.

- Crucial problems, concerning the firm's competitiveness; more dangerous than the preceding ones, they endanger the firm's future if the tension thresholds are superceded in favor of the breaking ones.

Tension thresholds correspond to „problems whose intensity amplifies during the opening stage and which either did not exist during the creation period or were overshadowed by other concerns" (Julien, Marchesnay, 1988). If the problems' intensity increases, the breaking threshold is reached, when the firm's vulnerability is maximal. Table 2 allows a schematization of the opening problems' intensity degree.

It shows that the lack of team spirit and the difficulty of segmenting the customers represent the most important problems, as they endanger the firm's survival.

The specialists have noticed, with no exception, that the firms never reach their monthly rhythm of activity; they reach only 60–70%.

A firm's success and failure seem to have a double dimension, both quantitative and qualitative: quantitative because they can be measured starting from ratios, and qualitative because they rely on the subjective appreciation of the one who measures and/or of the one interviewed on these matters. Success, as well as failure, becomes a multidimensional notion hard to measure precisely and uniformly. It is impossible to say that an initial success announces a future success or that failure at some point foretells bankruptcy.

Table 2. Nature and intensity of the opening problems

General problems	Crucial problems	
Level 1	Level 2: tension threshold	Level 3: breaking threshold
Technical set-up: • Production organization • Human resources organization	–	Lack of team spirit
Administrative constraints	–	–
Searching providers	–	–
Attracting customers	–	Difficulties in segmenting the customers
Attracting capital	Insufficiency of firm's funds	–

Source: C. Fourcade (1988), p. 49.

Failure can turn into success later on, if the entrepreneur knows to draw the right conclusions and to apply them rapidly. Moreover, the continuously changing internal and external conditions can influence the entrepreneur's goals.

A firm's success or failure during the opening stage cannot be explained by a single factor, as the firm is faced with a multitude of problems more or less related to one another.

Causes of failure

From a study (Terrier, 2002) achieved in 1982 by CREDA (Business Law Research Center) on a sample of small firms that failed, the result was the following:

- Half of the most fragile firms were less than 5 years old;
- 85% of the firms are faced with managerial and financial structure problems;
- most frequently, the managerial errors are attributed to the managers' aging, to their lack of authority or incapacity to master the changes in the firm and in the firm's environment;
- there are frequent imbalances of the financial structure (especially the capitalization) which diminish the firm's rentability and weaken it.

Another study was achieved on a sample of 244 failing firms. The study contains 43 possible bankruptcy causes. The study led to the discovery of 5 significant categories of causes: activity reduction (33.2% of all the firms), rentability decrease (17.6%), specific treasury problems (18.6%), managerial problems (23%), accidental causes (7.5%).

Detailed causes of failure are presented in Table 3.

Table 3. The most frequent causes of bankruptcy

Cause	Type of cause	% firms
Decreasing demand in the long term	Exogenous	15.7
Bankruptcy of some important clients	Exogenous	8.6
Accidental demand drop	Exogenous	8.2
Manager's incapacity	Endogenous	6.2
Inadequate strategies	Exogenous	5.2
Disorganization of the managerial team	Endogenous	5.2
Manager's insufficient technical training	Endogenous	5.2
Ineffective price policy	Endogenous	5.2
Loss of important clients	Exogenous	4.5
Suppression of credits in a short term	Exogenous	4.5
High personnel expenses	Endogenous	4.1
Rigidity of selling prices	Exogenous	3.4
Used tools and equipments	Endogenous	2.6
Manager's health problems	Exogenous	2.3

Source: O. Terrier (2002), p. 82.

The above-mentioned studies allow the drawing up of a list of the exogenous causes:

• reduction of the openings (market reduction or tendency of demand decrease; bankruptcy or loss of significant clients, unfavorable economic conjuncture);

• reduction of the profit margins (increase of the raw materials' price without the possibility of reflecting this increase in the selling prices; increase of the salarial costs; appearing of juridical or fiscal constraints);

• consolidation of the concurrence (appearing of new products, appearing of new concurrents with much lower prices).

The studies also highlight the preponderance of the endogenous causes in the firm's failure and among them the preponderance of managerial errors (between 32% and 85%).

If the risks of bankruptcy are detected in time or if they can be reduced, for instance through an alert procedure, small firms' managers can sometimes reestablish the situation by applying corrective measures. If the worsening of the situation is noticed too late or is too serious, the possibilities of internal redress are insufficient. In this case, external help can be required (for instance it is possible to conclude agreements of amiable payment regulation with the creditors).

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Summary

The author outlines main reasons for maladjustment of small and medium enterprises to market conditions. The causes may be divided into several groups: related to commercial offer management, company's strategy management, use of human resources in management and entrepreneurial initiative. In various conditions these factors variously influence success or failure of small and medium enterprises.