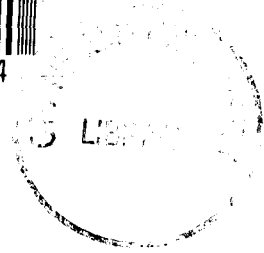




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**SWP 14/88 STRATEGIES FOR SUCCESS AND ROUTES
TO FAILURE**

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CHAPTER 3

STRATEGIES FOR SUCCESS & ROUTES TO FAILURE

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1. FROM BIRTH TO DEATH

Most businesses are born to die or stagnate. It is no wonder that we are fascinated by those few that grow. It is also a natural instinct to pore over the remains of dead businesses to try to gather portents for the future.

There is a substantial turnover in numbers and types of businesses in all western countries. However, in the United Kingdom, whilst the number of deaths is fairly constant, the number of new firms being set up is rising. By 1984 the surplus of firms being set up over those dying was over twice that in 1980 - 36,000 compared to 16,000. That gave a net surplus between 1980 - 1984 of 140,000 firms.

This is a pattern replicated in most of Western Europe¹ and the USA. Many countries report rising death statistics for businesses but almost all (with some notable exceptions such as Denmark) report birth rates that are rising more steeply. Thus, unlike Britain, many countries (such as USA) report a higher rate of business turnover. Britain's birth and death statistics now compare favourably with most countries.

What seems a peculiarly British problem is getting businesses to grow, turning successes into companies of truly international scale. ICL, the British computer business which is almost five decades old, is now smaller than the Apple Corporation founded just over a decade ago. In 1960 the car manufacturer Jaguar was roughly the same size as Mercedes-Benz. Today, Daimler-Benz is some 15 times the size of Jaguar and of comparable size to ICI. Indeed, ICI is now smaller than two of the top three West German chemical companies.

This problem shows itself in the relative size of Britain's small business sector. Whilst in general, the small business sector, employs between 60% (France) and 83% (Italy and Republic of Ireland) of the work-force, in Britain it employs only 37% of the workforce. Two out of three of those officially classified as self-employed in Britain do not employ anybody else, and this total has been growing rapidly in recent years.

Stanworth and Curran² have argued that, as small business owners place great value on independence, embarking on a high growth strategy might lead them to feel that their independence is threatened. Others³ have argued that small business owner-managers are aware of their lack of management ability to cope with growth and therefore simply reject it.

What is true in all countries⁴ is that most small businesses grow only in the first few years after start-up and then stabilise to provide the owner manager with an acceptable, independent life style. At this stage the business is providing sufficient sales to ensure survival and to provide an adequate return on investment and standard of living. Most owner managers seem satisfied at this 'comfort level' and their business does not grow beyond it. However, the 'comfort level' does seem to vary from country to country.

2. PORING OVER THE REMAINS

Businesses can die in many different ways.....and not always for regrettable reasons. Often entrepreneurs cease trading in one business to pursue another opportunity. Debts may be paid and employees found jobs in the new business. This dynamism is vital. It is evidence of the flexibility that can make small business so market responsive.

However, when the business dies because of insolvency leading to liquidation or bankruptcy, it is likely that creditors will be left unpaid, jobs will be lost and the businessman himself may lose money and prestige, causing hardship to his family. It is this that business analysts try so hard to predict and to prevent. Yet most business deaths do not involve bankruptcy or liquidation. Most businesses simply choose to stop trading, the owners changing to another activity. In the USA and the UK only about 10% of business deaths are due to insolvency.

Various studies give an insight into this process. One by Ganguly and Bannock⁵ looks at VAT registrations and deregistrations in the UK over the period 1973-82, which it uses as a proxy for new firm births and deaths. They conclude:

1. 40 - 45% of businesses will still be trading after 10 years.
2. Year in, year out, about 9% of businesses can be expected to die (deregister): varying between 8% and 15%. However, as might be expected, the early years are the riskiest and 60% of deaths (deregistrations) take place in the first 3 years of existence. Thus, about one third of businesses cease trading within their first three years of life.
3. This profile of failure is not significantly different between sole traders/partnerships and companies.
4. There are few significant differences between individual sectors. However, the service sector, overall, tends to have a higher failure rate than manufacturing and construction and within that, the retail sector has actually seen a fall in the number of businesses in recent years. Unincorporated businesses tended to have a better survival record in production, construction, transport, wholesale and motor trades. Companies on the other hand were better in agriculture, retailing, professional and financial services and catering.

Other UK research by Stewart and Gallagher⁶ using an alternative data base, the files of credit rating agency Dun and Bradstreet, broadly supports these conclusions. This data base covers about one seventh the number of firms in the VAT studies. However, this still represents about 200,000 firms over the period 1971-83, and has the advantage that it can distinguish those firms that die or cease trading due to insolvency. It highlights the fact that insolvencies increase in times of recession. A surprising result is that for the smallest firms (1-19 employees) the proportion ceasing to trade (for any reason) actually falls during times of recession. Deaths fell from 7.3% in 1971-81, to 6.3% in 1981-82, and to 4% in 1982-83 as the recession worsened. Whilst the death rate was higher for small firms than large firms in 1971-81, generally the reverse was true by 1982-83. Stewart and Gallagher suggest that this was, in the main, because there were fewer new business opportunities and shortages of capital in the recession of 1981-83. Consequently entrepreneurs were forced to continue in their current business.

This pattern is replicated in the USA where a study by Harris⁷ using a similar Dun and Bradstreet data base supported these conclusions. However, Harris did conclude that small firms in the USA were more likely to cease trading (for any reason) than large firms, under all economic conditions.

3. ANATOMY OF SUCCESS

It would be naïve to think that opportunities for growth exist for all small businesses. Indeed certain sectors of any advanced industrial society are almost exclusively the preserve of large businesses for example where significant economies of scale exist and can only be achieved by large plant size. Equally, it would be naïve to suggest that there is an unfailing formula for generating growth in a new business.

Nevertheless, the elements of success may be broadly defined:

The Entrepreneur The entrepreneur is the key to the successful launch of any business. He is the person who perceives the market opportunity and then has the motivation, drive and ability to mobilise resources to meet it. However, it is difficult to create a picture of him. Barrow⁸ tries to catalogue certain typical characteristics:

- Self confident all-rounder....the person who can 'make the product, market it and count the money, but above all they have the confidence that lets them move comfortably through uncharted waters'.
- The ability to bounce back....the person who can cope with making mistakes and still has the confidence to try again.
- Innovative skills....not an 'inventor' in the traditional sense but one who is able to carve out a new niche in the market place, often invisible to others.
- Results orientated....to make the business successful requires the drive that only comes from setting goals and targets and getting pleasure from achieving them.
- Professional risk taker....to succeed means taking measured risks. Often the successful entrepreneur exhibits an incremental approach to risk taking, at each stage exposing himself to only a limited, measured amount of personal risk and moving from one stage to another as each decision is proved.
- Total commitment....hard work, energy and single mindedness are essential elements in the entrepreneurial profile.

However, the entrepreneurial characteristics required to successfully launch a business are often not those required for growth and even more frequently not those required to manage it once it grows to any size. At the very least the role of the entrepreneur needs to change with the business as it develops and grows. However, all too often he is not able to make the transition.

The Product/Service Idea. The product/service idea is an element in the success of any business, but its importance is often overstated. An innovative entrepreneur can find ways of making existing products and services just that little more attractive to the customer. In 1970 David Dutton opened the first Pizzaland restaurant in London copying ideas he had seen in the USA when he was at Harvard Business School. He opened some 30 Pizzalands before selling the business onto United Biscuit which expanded the chain further. Almost ten years later Bob Payton opened his first Chicago Pizza Pie Factory, also in London. That business now has a turnover in excess of £20M per annum with restaurants in Barcelona and Paris. The product is different - deep pan pizza - and the atmosphere and enthusiasm of the restaurant staff are very different. There is no such thing as an ordinary pizza restaurant.

Nevertheless, the product must be right for the market and available at the time when the market wants it. The list of business failures abound with products 'ahead of their time'. The key to any successful business is market responsiveness....understanding the customer and their needs. And customers normally expect uniform quality and reliability of product across all elements of the marketing mix; product, price, promotion and channels of distribution.

Management Understanding the customer and how the product or service can be made to fit their needs is a question of good management. Understanding the economics of the business's products or services and how they can be turned to the advantage of the business is a question of good management. Understanding which opportunities to pursue and equally which to avoid can also be a question of good management.

As the business grows the management style adopted by the entrepreneur needs to change, but equally the entrepreneur needs to plan its further development systematically and to apply management controls more effectively.

Figure 1 about here

Good management means directing all the resources of the business; design, production, quality control, finance, sales and customer service; towards the aim of satisfying customer needs. It is the mechanism by which the entrepreneur can turn the product/service idea into a successful business.

The final element in success is good luck....being in the right place at the right time. Every successful entrepreneur has luck although how much is happenstance and how much is hard work is another question.

4. STRATEGIES FOR SUCCESS

The average size of businesses varies from industry to industry. For example, the average size of a chemical firm is very large, whereas, the average size of retail firms is relatively small. The most fundamental reason for this is the extent to which economies of scale affect an industry; that is, how the total cost per unit produced changes as more units are produced. Generally, this can be expected to decline up to some point; for example, as an expensive piece of machinery is used more fully. However, beyond this point unit costs may start to increase; for example as economies of scale of production become increasingly offset by rising distribution costs. The potential of economies of scale are often greatest in capital intensive industries like chemicals.

Figure 2 about here

This is shown diagrammatically in Figure 2. Total costs include production, selling and distribution costs and are therefore dependent upon the state of technology, the size of the market and the location of potential customers. The unit cost for industry A. turns up at a relatively low level of output, implying the optimal size of firm is relatively small in contrast to industry B. where there are considerable economies of scale. Porter⁹ calls these 'fragmented' industries, where economies of scale just do not exist and large firms therefore cannot dominate the industry.

As Dewhurst and Burns¹⁰ have pointed out, small businesses will not be able to survive, in the long run, in an industry where economies of scale exist and are important.

This bold statement must, of course, be explained, since we all know of examples where small firms have survived and prospered in industries where economies of scale exist. There are two major reasons for this.

1. The market or product is new and economies of scale are being developed. Firms have not yet had time to grow to their optimal size. In this case small firms must grow and aim to become large firms early in their life cycle.... simply to ensure their survival. These are the 'big bang' companies, they tend to be the glamorous ones that make the news headlines. However, obtaining market dominance is a high risk strategy and this road to high growth has many casualties on the way.
2. While economies of scale of production exist the market for the product is limited, either in total or geographically, and the theoretical optimal size is not achievable. This happens particularly in highly specialised industries. But specialism can be product or market based. Indeed having a differentiated, specialist product or service often goes hand in hand with having a well targeted market segment. This is called following a 'niche' strategy. It is important for small firms since it offers a better chance of selective, sustainable growth than the 'big bang' strategy.

An example of this is the micro-computer industry. Born in the late 1970s with unknown demand for its products and no established producers, it has grown rapidly. However, the industry offers substantial economies of scale, particularly in R & D for hardware and software. Consequently, the market has consolidated with many small

firms going out of business. The survivors have been one of two types of firm. Firstly, firms like the Apple Corporation, which recognised that the industry would eventually be dominated by a few large firms offering low cost or premium quality products. Apple grew rapidly, grabbing market share world wide so that it is now in a good position to compete with the big company entrants such as IBM. Secondly, the firms like Sun Computers which specialised in CAD/CAM equipment and targetted quite specific market segments. As often happens, it has been the middle sized firm which has pursued neither strategy which has suffered in this industry.

There is a strong element of luck in the 'big bang' strategy or put more scientifically it is a high risk strategy. Often firms only realise that it is the strategy they must adopt as the market or technology for the product or service develops. This is because the company needs to establish:

1. That the technology offers the economies of scale (and often cost curves can change dramatically over time).
2. That these economies are in some way important to the customer (through lower price or other advantages).
3. That they are achievable, given the market size.

Certainly, 'niche strategy' offers the better chance of success. It involves filling or creating gaps in the market that big firms find unsuitable for their large investment capacity. It involves specialising in customers or products, not methods of production. It emphasises the non price elements of the marketing mix, such as quality, and satisfying a small, clearly defined target market or segment which have these specialised needs. Frequently, small firms stress their inherent strengths in innovation, flexibility or personalised service.

One apparent problem with niche strategy is that it is based, by its very nature, on a limited market. However, what might be limited for a large company often offers wide opportunities to the small. Frequently, entrepreneurs pursuing niche strategies find further growth by diversification. This diversification is particularly effective if it pursues further niche opportunities.

The initial start-up of a business is often related to a 'disturbance event' in the owner-manager's life¹¹. Sometimes growth of a business beyond the 'comfort level' is triggered by a similar 'disturbance event' such as a change in competition or customer tastes. Frequently these events pose distinct threats to the survival of a business and failure to react can lead to failure of the business. A key element after the 'disturbance event' is often the presence of a 'mentor' or 'credible example' who coaxes the business and the entrepreneur through this difficult phase¹².

5. THE LIFE CYCLE DYNAMIC

The life-cycle concept is a relatively simple idea which provides a useful framework for looking at the development of a small business. The idea is that every product or service, and therefore any business tied to just one product or service, faces a life cycle of five stages, shown in Figure 3.

Figure 3 about here

Stage 1: Introduction. This is the stage where the product or service is introduced and encounters a certain amount of consumer ignorance and resistance. Sales are low and growing slowly and profits are low or negative.

Stage 2: Take-Off. This is the short period when the product or service becomes very popular. Sales and profits grow rapidly, attracting new entrants to the industry.

Stage 3: Slowdown. After a while, the rapid growth slows down as competing products or services enter the market and it becomes saturated. Profits might actually dip at this stage.

Stage 4: Maturity. Eventually the market becomes saturated and sales are static. Product sales may simply be for replacement. With some products or services this period may be relatively short, for others it can last for years. Often it can be extended by giving the product or service a face-lift, as car manufacturers regularly do.

Stage 5: Decline. After some time, sales will start to decline as substitute, improved products or services become more attractive and the old product becomes obsolete.

Different businesses have different life cycle curves. Our 'big bang' company will experience a rapid and dramatic take off. It also faces the danger of an equally dramatic decline into bankruptcy. The 'niche' business will probably plateau at a lower level of sales but will have greater certainty of an elegant maturity.

As the business takes off the owner manager will have to recruit more people. His style of management probably needs to change with the life cycle of the business. The new, growing firm operates in an uncertain, unpredictable and often ambiguous environment. Whilst continuing as the risk-taker, always searching for new market opportunities, the entrepreneur needs to develop his team and delegate more and more. Delegating to those closest to the problem necessitates tolerating mistakes, supporting and protecting staff as they grow into their jobs, encouraging them to experiment and test the market and rewarding their successful initiatives. Inevitably, there will be some confusion and ambiguity of tasks and a certain amount of internal competition. However, organisational structures need to be formalised as the business grows.

As the business approaches maturity the environment should become more stable and predictable and the emphasis probably shifts to control. The owner-manager may well become less of a risk taker as he has more to lose. The emphasis will probably also shift to maintaining stability, fine tuning and structuring the business more tightly; coordinating activities, eliminating overlap, careful analysis.

This move towards greater control will necessitate more formal systems. Entrepreneurs start out able to control their affairs by physical inspection and personal discussion, but as the scale of activities increases, they have to rely increasingly on written information supplied on a regular and timely basis. The successful business learns this lesson early in the take off stage.

A new business therefore faces a rapidly changing economic environment which, in turn, places great, and rapidly changing demands on the owner manager. Figure 4 breaks down stages 1 and 2 of the traditional life cycle into four distinct phases when the economic imperatives and problems faced by the owner manager change rapidly.

Figure 4 about here

Phase 1 : Existence and Survival. This is the crucial phase dealt with in the preceding chapter when the owner manager is larger on his own, probably doing a little of everything himself and supervising any employees directly. There are unlikely to be any formal management control mechanisms .

The major problem facing the entrepreneur is finding customers. As the business develops, those with real growth potential will be developing the uniquenesses in the product offerings that are so important later on. Cash flow is the major control imperative. Many business will not survive this first phase, mainly because they never gain sufficient customer acceptance and they run out of start up capital.

Phase 2 : Consolidation and Control. This is the phase when the owner manager is proving that he can obtain repeat sales and that the business is really sufficiently profitable to provide the opportunity he is seeking. The business with real growth potential must be refining its unique selling proposition by this phase. Cash flow remains crucial but new budgets and targets will start to be set. Organisations remain simple. As in Phase 1, the owner manager is the business and control still tends to be informal, however, by this stage any business that is not planning its cash flow is unlikely to have survived.

Most businesses will not develop beyond this phase. Either the market potential for growth will not exist or the owner manager will decide he does not want to see the business grow. If the business is to stay at this level then some basic financial, marketing and production, ^{control} systems must come into place. As long as the environmental changes do not destroy the market niche or inefficient management squander the resources, the business can probably stay at this phase indefinitely.

Phase 3 : Control and Planning. Those businesses that have growth potential which the owner manager wishes to capitalise upon now come into a crucial phase of refining control and marshalling the resources needed for growth. The most important element in this is recruiting, delegating to and developing staff. Control systems have to be installed to monitor subsequent growth and this should provide the opportunity to improve margins by controlling costs and even gaining some modest economies of scale. In this phase the owner manager needs to set down his strategic plans and look for the resources needed for the next phase. He must also prove that he can combat the competition that will inevitably emerge if the business is successful.

Phase 4 : Expansion. This is the exciting phase when the business really does take off. However, to do so, there must be sufficient good staff in place with their roles clearly defined and their activities properly coordinated. Many entrepreneurs really just cannot do this and therefore the premature expansion can lead to failure for the business. At this stage the business must be sufficiently strong that it is able, not only to combat competition, but to improve its competitive situation. This is the phase where professional management starts to merge. Indeed, many entrepreneurs who recognise

their inability to cope with this phase will sell out to larger firms who will put in the professional staff to manage this important expansion.

It is very difficult to put a time scale on these four phases since each business and market opportunity is so very different. However, each phase probably lasts at least one year. Having said that, in the UK, Sock Shop came to the Unlisted Securities Market in 1987 after only five years....a listing that was over 50 times oversubscribed.

When the business comes to the third stage of its development - slowdown - the emphasis is very much on consolidation and effective control. The business must have strong accounting controls which enables considerable fine tuning and the achievement of economies of scale.

Figure 5 about here

Churchill and Lewis¹³ have proposed a similar growth model to this. They identify eight key factors which determine the success or failure of a business, four relating to the owner manager and four relating to the company. These factors change in importance as the business develops, as shown in Figure 5. The factors are:

Owner-manager

1. Owner's goals for himself and the business.
2. Owner's operational ability in key business areas.
3. Owner's managerial ability and willingness to delegate responsibility and to manage the activity of others.
4. Owner's strategic abilities.

Company

5. Financial resources, including cash and borrowing power.
6. Personnel resources (quality and quantity) particularly at management levels.
7. Systems resources, in terms of information, planning and control systems.
8. Business resources, including customer goodwill, market share, supplier relations, manufacturing and distribution process, technology and reputation, all of which give the company a position in its industry and market.

Figure 6 about here

In fact the life cycle concept tells only part of the story. Before a product or service is ever launched money will have been spent undertaking market research, developing the product, installing new equipment and training staff. Figure 6 shows the probable cash flow cycle alongside the life cycle curve. It demonstrates the need for adequate funding prior to a product launch and indeed well into its take off stage. This cash flow pattern can frequently lead under-capitalised firms into situations of over-trading and illiquidity when they, paradoxically, have a successful product and a growing business.

A study by Ray and Hutchinson¹⁴ of 'supergrowth' companies - companies which grew rapidly to a stock market quotation - compared to a matched sample of 'passive' small firms which did not grow to floatation underlines these conclusions. The results are summarised in Figure 7. It is noticeable that the 'supergrowth' companies were considerably more focussed in their objectives with a strong emphasis on forecasting financial data on a regular and timely basis; particularly cash flow but also profit and sales. The changing style of management and organisational structure is also apparent as the companies move through their life cycle.

Figure 7 about here

The approach of maturity will also lead to its own set of problems. Products or services can have the mature phase of their life cycle extended by facelifts. However, at the end of the day a business often has to diversify to maintain its growth. This is perhaps a more immediate problem for the business following a 'niche' strategy with a relatively limited market. Where to go next?

6. PRODUCT MARKET STRATEGIES FOR FURTHER GROWTH

In its search for further growth, a business has four options, illustrated in the product market matrix in Figure 8.

1. It can stay with its base product or service and its existing market and simply try to penetrate the market further. This is dealing very much with the familiar and is normally the lowest risk option. Although the point will come when further penetration is not possible or economic.
2. It can develop related or new products for its existing market. For example, an off licence might start to sell soft drinks or cigarettes. This is called product development.
3. It can develop related or new markets for its existing products. The off licence might open a new branch in a nearby area of the town, or it might try selling directly to restaurants. This is called market development.
4. It might try moving into related or new markets with related or new products. The off licence might try selling cigarettes directly to restaurants. Since this strategy involves unfamiliar products and unfamiliar markets it is high risk.

Figure 8 about here

It is generally recognised that in comparing investment in related and unrelated areas, not only are the risks of the former lower, but also the returns are higher. Market and product development should therefore be incremental from the familiar to the unfamiliar. Further, it is claimed that market developments are to be preferred to product developments 'because developing new customers is less risky than developing new products' ¹⁵

The strategies discussed above are called 'horizontal' strategies. Two further strategies for growth are open to the small firm. Firstly, 'backward vertical integration'; the firm becomes its own supplier of some basic raw materials or services. Secondly, 'forward vertical integration'; the firm becomes its own distributor or retailer. Both strategies entail new product or service technologies and new customers and are therefore relatively risky.

It is generally accepted that vertical integration is not successful for small firms. ¹⁶ Perry ¹⁵ suggests that vertical integration should only be a reaction to competitor's activities, for example to prevent them from controlling raw materials and services. He also points out that a period of consolidation should follow any growth surge, 'not because of organisational constraints but because of financial and entrepreneurial/managerial constraints'.

7. ROUTES TO FAILURE

Businesses fail, that is, cease to trade against the will of the owner-manager, because of the interaction of the personal characteristics of the entrepreneur with the managerial situation he faces within his business. The personal characteristics of the entrepreneur are particularly important factors in the early period of a business's life - when the failure rate is highest. However, they do not on their own explain the actions of the entrepreneur and his business.

In a survey of the literature, Berryman ^{1,7} lists such personal problems as delegation, reluctance to seek help, excessive optimism, unawareness of the environment, inability to adapt to change and thinness of management talent. It appears to be generally accepted that entrepreneurial firms reflect the personalities of the entrepreneurs who build them up. However, the qualities which distinguish between success and failure are often disputed. The qualities required to initiate a business are not those recognised to manage it as it approaches maturity. De Carlo and Lyons ¹⁸ point to the lack of guidelines on 'how to identify the skills required at different stages' as well as the lack of research 'to confirm which stages do exist and to determine whether all businesses do, in fact, pass through all stages'. It is also apparent that entrepreneurial personalities as well as management characteristics vary from industry to industry. ¹⁹

In looking at the managerial incompetences contributing to failure, Berryman, lists some 25 different deficiencies grouped under the general headings of accounting deficiencies, marketing deficiencies, lack of adequate finance and other areas (such as excessive drawings, deficiencies in accounting and managerial knowledge and advice as well as personal problems). Accounting problems are mentioned most frequently in the survey. All too many small businessmen rely on their auditors to produce out of date accounts on which to base their decisions. However, it has been pointed out that many of these problems are merely symptoms of incompetence rather than underlying causes. Although they do highlight areas of action for advisers and trainers.

Larson and Clute's ²⁰ empirical research is one of the pieces surveyed by Berryman. The personal characteristics and managerial deficiencies they say lead to failure are shown below:

Personal Characteristics

- Exhibits exaggerated opinion of business competency based on knowledge of some skill.
- Limited formal education.
- Inflexible to change and not innovative.
- Uses own personal taste and opinion as standard to follow.
- Decision making based on intuition, emotion and non-objective factors.
- Orientated to past, ignores future.
- Does little reading in literature associated with business.
- Resists advice from qualified sources but, paradoxically, accepts it from their least qualified.

Managerial Deficiencies

- Cannot identify target market or target customers.
- Cannot delineate trading area.
- Cannot delegate.
- Believes advertising is an expense not an investment.
- Only rudimentary knowledge of pricing policy and strategy.
- Immature understanding of distribution channels.
- Does not plan.
- Cannot motivate.
- Believes problems not his making and a loan would solve everything.

Figure 9 about here

The personal characteristics of the entrepreneur interact with the management defects inherent in the firm. However, the crisis that triggers the decline to failure is often brought about by some outside factor, as shown in Figure 9. Berryman talks simply of economic, and seasonal conditions, personal problems and fraud, but more generally the outside factors may be changes in the market, customer tastes, competition or distribution channels. It may also be bad business decisions made by the owner-manager.

Argenti²¹ uses a slightly different model, talking simply about 'defects' and 'mistakes'.

Defects

- Autocratic, dominating chief executive heeding no advice.
- Chief executive also chairman.
- Skills on board unbalanced (e.g. too many engineers).
- No strong financial directors.
- No participating board of directors.
- No depth of professional management.
- No budgeting system.....particularly cash flow planning.
- No costing system.
- Failure to respond to change.

Mistakes

- High gearing.
- Overtrading.
- The 'big project' which exceeds the business's resources.

The interaction of all these factors leads to symptoms of failure. Some researchers insist that most managerial defects are simply symptoms. Others refer to accounting data that emerges many months or years after the events as the outward signs of the real problems. Argenti lists:

- Decline of many financial ratios.
- Creative accounting and window dressing to 'improve' profits.
- Failing staff morale and non-replacement or repair of equipment and facilities.

This insight into the process of failure is valuable, not only because it may help to avoid that event, but also because it reinforces so many of the lessons of success. However, understanding the process of failure, even being able to avoid it, is not the same as being able to predict that failure.

8. PREDICTING FAILURE

It is a natural human instinct to want to predict the future but it is something we shall never be able to do with absolute certainty. However, if it is possible to predict failure (insolvency leading to bankruptcy or liquidation) with an acceptable degree of certainty then it might be possible to take corrective action in advance of the event. As bankruptcy rates rise so does the interest in failure prediction models.

Most failure prediction models are based on financial variables. As such they look only at symptoms of failure rather than underlying causes and give only a limited insight into the process of failure. Symptoms show up after the inherent mistakes have been made. Using financial variables this time lag is likely to be further exaggerated since small firms are well known for their tardiness in producing accounts. Indeed for some, this might be a contributory factor in their failure.

These financial models fall into two categories. Firstly, 'univariate models' which attempt to predict failure based upon the level and trend of a single financial ratio. The best known of these was tested by Beaver²² using data from 79 US industrial companies. He compared the mean ratios of a group of failed companies with those of the companies that did not fail. The results are summarised in Figure 10. The ratio which proved the best predictor was that of cash flow to total debt. As with all ratios, its predictive ability declined as the period prior to bankruptcy lengthened. Error rates were 13% one year prior and 22% five years prior to bankruptcy.

Some care needs to be taken when assessing these error rates. Ideally, error rates for both the original test sample (on which the model was developed) and a 'hold-out' sample should be given, as is the case with Beaver. Also, simply to say that 13% of companies were misclassified as bankrupt or non-bankrupt is misleading. If I were to predict that no firm would ever go bankrupt then, given a large enough sample, my error rate would be under 1%, given that under 1% of firms go bankrupt in any one year. However, my error rate on failed firms (called a type 1 error) is 100% and a non failed firms (called a type 2 error) is 0%. Analysts are naturally far more interested in type 1 errors. Type 1 error rates are invariably higher than type 2 error rates.

Figure 10 about here

The second category is 'multivariate models' which use multiple discriminant analysis to combine a number of ratios to produce a 'z-score'. The best known model is that of Altman²³ which combined five ratios, with different weightings, to produce a more comprehensive profile of a firm. These results are also summarised in Figure 7. Whilst in the first year error rates are lower than those of Beaver's model, accuracy falls off sharply with time, until three years prior to bankruptcy the model performs no better than a naive random prediction model.

Multivariate models have been criticised for many reasons.²⁴ They would appear to be time and situation specific. Altman's model was based on data from fairly large manufacturing companies in the USA during the period 1946-65. When Ray and Hutchinson¹⁴ applied the model to their sample of UK 'supergrowth' companies, they discovered that nearly half of the companies would have been classified as bankrupt at some stage up to their floatation. The matched sample of 'passive' companies had a much lower proportion in this category.

Another model by Edmister²⁵ (Figure 10) looked specifically at small firms, using data from the US Small Business Administration. Overall this model produced an error rate of 7% one year prior to failure. However, Edmister had problems with data availability since he needed three years data to develop his model and only 15% of those firms in the SBA data base could meet that requirement. This led to problems of validation.

The lack and lateness of financial data for small businesses makes the use of these models seem questionable. To make matters worse, significant problems exist in establishing the reliability and consistency of the accounting data they use. Rising interest rates, a recessionary environment, the availability of credit and other macroeconomic factors are also likely to particularly affect small businesses. All in all, financial variables are unlikely to prove practical predictors of failure in small firms. However, research still continues.

9. SMALL CAN THINK BIG

The Prussian military strategist Von Clausewitz said:

**'Have a good object in view'
....In other words, think big!**

Small firms can and do grow. Entrepreneurs can and do make a fortune from the growth of their business. Some will be able to grow and adapt with the business, others will realise that they cannot change and hand the business on to 'professional managers'.

Much of government effort and public attention is directed towards new business start-ups. Creating conditions for second-stage expansion is important for the economies of all countries.

There are lessons to be learned from business failure, even if failure cannot be reliably predicted. More important, however, are the simple strategies for growth that have proved successful for so many firms. These involve a thorough understanding of the customer, the market place and the economics of the product or service. The reality is, however, that most small firms will not follow these strategies. Most small firms will not grow. Most small firms are born to die or stagnate.

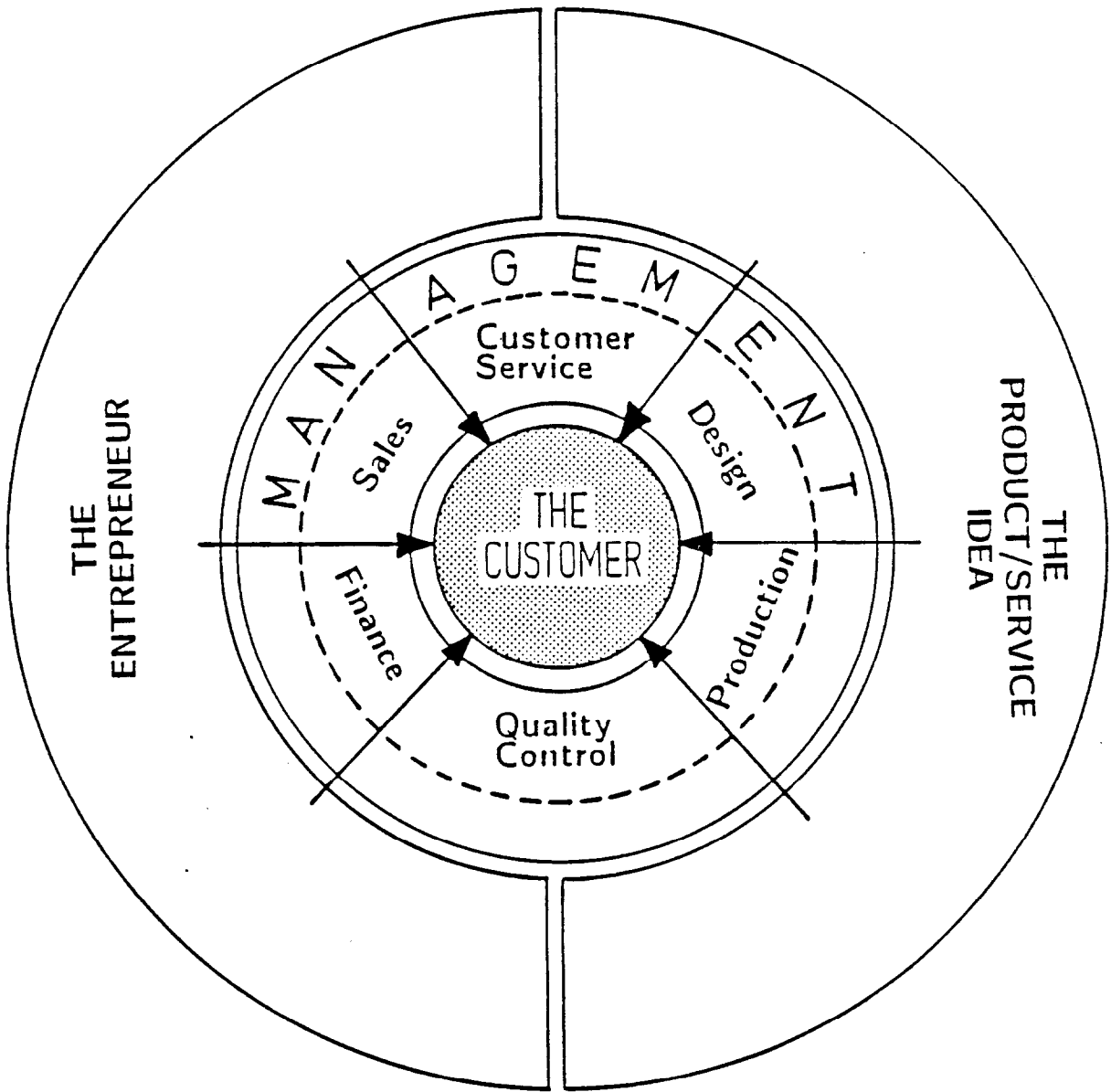
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Figure 1

The Elements of Success



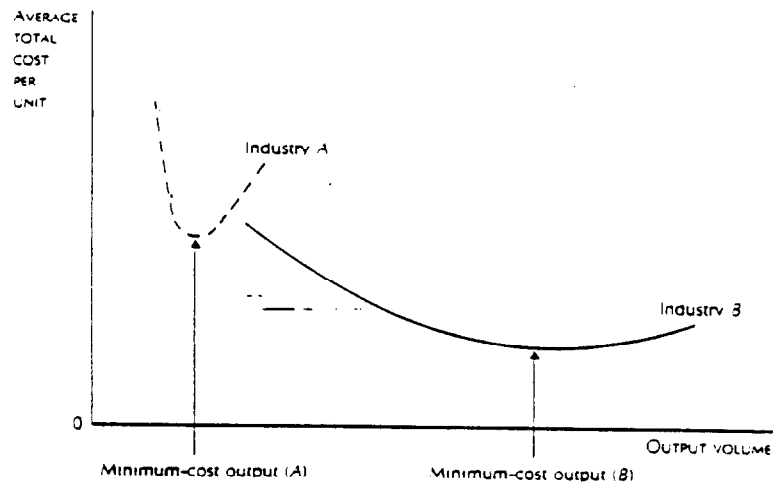


Figure 2 Long-run average cost curves

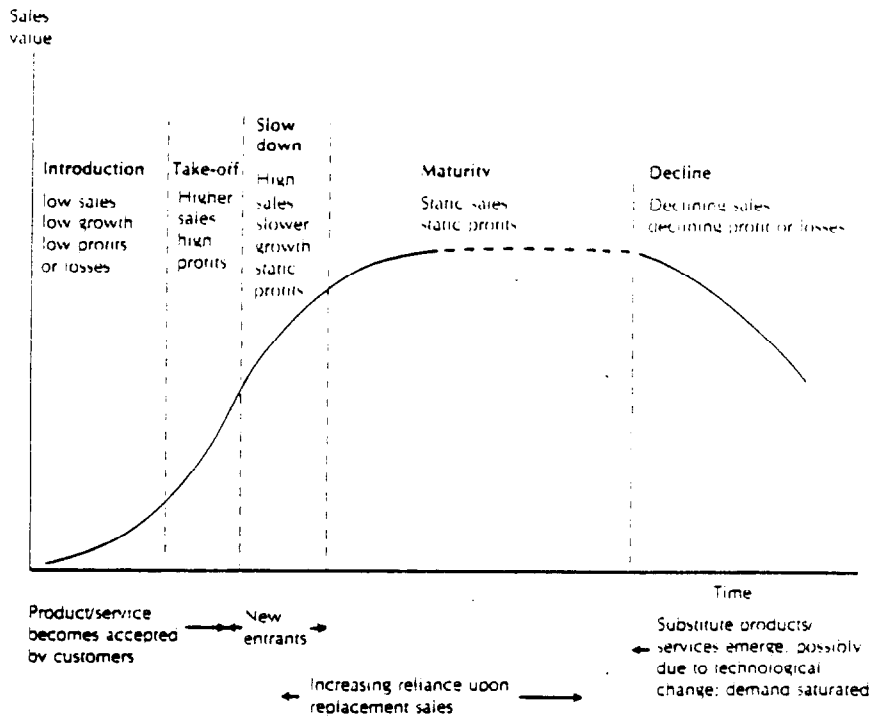


Figure 3 The life-cycle curve

Figure 4

New Business Life Cycle: Introduction and Take Off

	INTRODUCTION		TAKE-OFF	
	PHASE 1	PHASE 2	PHASE 3	PHASE 4
OBJECTIVE:	SURVIVAL	CONSOLIDATION & CONTROL	CONTROL & PLANNING	EXPANSION
MANAGEMENT STYLE AND ORGANISATION:	<ul style="list-style-type: none"> • Owner <u>is</u> business • Owner does everything • Direct supervision of staff • Simple organisation • Informal systems • Opportunity driven 	<ul style="list-style-type: none"> • Owner <u>is still</u> the business • Simple organisation • Informal systems • Some supervision and control • Cash flow planning 	<ul style="list-style-type: none"> • Recruit staff • Delegate to staff • Encourage staff to develop & grow into jobs • Tighten controls on staff • Strategic planning 	<ul style="list-style-type: none"> • Clearly defined staff roles • Further delegation • More decentralisation • Greater coordination and fine tuning of activities • Emergence of "professional" management • Operational and strategic planning
MARKETING PROBLEMS:	<ul style="list-style-type: none"> • Getting Customers • Developing unique selling proposition 	<ul style="list-style-type: none"> • Generating repeat sales • Proving unique selling proposition 	<ul style="list-style-type: none"> • Proving ability to combat competition • Further, steady market penetration 	<ul style="list-style-type: none"> • Improve competitive situation • Major expansion (New market/products)
ACCOUNTING AND FINANCE PROBLEMS:	<ul style="list-style-type: none"> • Cash flow • Testing projected margins and breakeven 	<ul style="list-style-type: none"> • Cash flow • Proving margins and breakeven • Greater financial control 	<ul style="list-style-type: none"> • Tighten financial control • Improve margins • Control costs 	<ul style="list-style-type: none"> • Tight financial control
FUNDING:	<ul style="list-style-type: none"> • Owner's funds • "Borrowed" resources <ul style="list-style-type: none"> - leasing - subcontract • Bank borrowing 	<ul style="list-style-type: none"> • Owner's funds • "Borrowed" resources <ul style="list-style-type: none"> - suppliers - leasing - subcontract • Greater bank borrowing 	<ul style="list-style-type: none"> • As before but search for expansion capital • Possible 1st phase venture capital 	<ul style="list-style-type: none"> • Venture capital for expansion

FIGURE 5 : KEY FACTORS IN THE SUCCESS OR FAILURE OF A NEW BUSINESS

		INTRODUCTION		TAKE-OFF		SLOW DOWN
		SURVIVAL	CONSOLIDATION & CONTROL	CONTROL OF PLANNING	EXPANSION	
INDIVIDUAL	OWNER'S GOALS	***	*	***	***	**
	OWNER'S OPERATIONAL ABILITY	***	***	**	**	*
	OWNER'S MANAGEMENT ABILITY	*	**	**	***	**
	OWNER'S STRATEGIC ABILITY	*	**	***	***	***
BUSINESS	FINANCIAL RESOURCES	***	***	**	***	**
	PERSONNEL RESOURCES	*	*	**	***	**
	SYSTEMS RESOURCES	*	**	***	***	**
	BUSINESS RESOURCES	***	***	**	**	*

*** CRITICAL

** IMPORTANT BUT MANAGEABLE

* MODESTLY IRRELEVANT

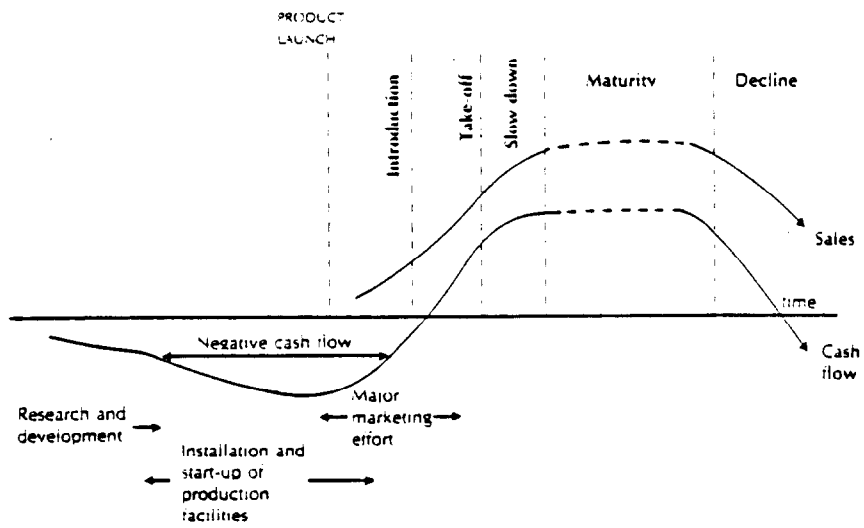


Figure 6 The life-cycle curve and cash flows

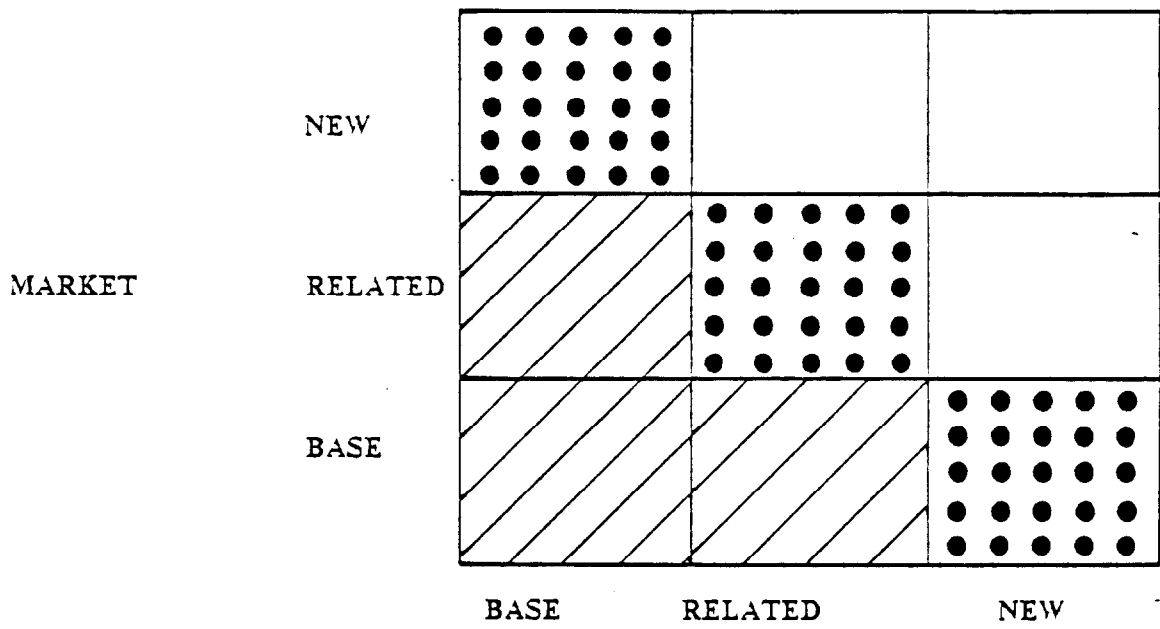
Figure 7

Supergrowth and Passive Company Characteristics

	'Supergrowth' Companies	'Passive' Companies
OBJECTIVE	Maximise profits Increase sales	Less emphasis on profits More on independence
ORGANISATIONAL STRUCTURE	'Tree' structure Development of 'teams' 'Clover leaf' emerging	'Tree' in well established firms
STYLE OF MANAGEMENT	Autocratic to start Consultation emerging	Paternal
STRUCTURE OF INTERNAL ACCOUNTING	Strong movement to Profit Centres	Less emphasis on Profit Centres
HISTORICAL DATA	Monthly or weekly P/L and balance sheet	Similar
FORECAST DATA	Strong on cash flow Trend to monthly forecasts	Very little
KEY VARIABLES	Cash flow Profitability Sales	More emphasis on supplier relation- ships

Figure 8

PRODUCT MARKET MATRIX



PRODUCT/SERVICE TECHNOLOGY

INCREASING RISK →



← INCREASING FAMILIARITY

Figure 9

A FRAMEWORK FOR BUSINESS FAILURE

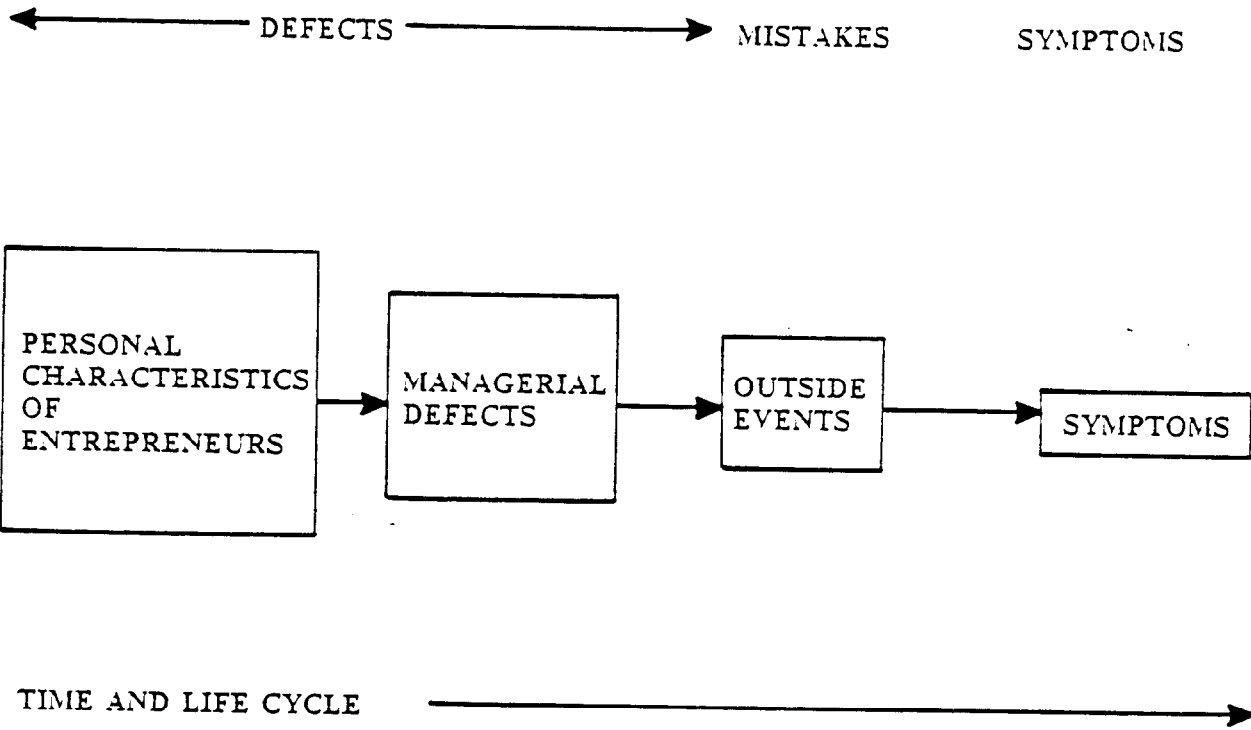


Figure 10

Bankruptcy Prediction Models

RATIOS	TYPE & NO. FIRMS	PERIOD	BEAVER			ALTMAN			EDMISTER
			Cash flow/total debt Net income/total assets	Total debt/total assets Working capital/total assets Current ratio No credit interval	Working capital/total assets Retained earnings/total assets	Earnings before interest and tax/total assets Market value equity/book value of total debt Sales/total assets	Funds flow/current liability Equity/sales Net working capital/sales Current liabilities/equity Inventory/sales Quick ratio		
	79 industrialists	-							
	33 manufacturers	1946 - 65							
	42 SBA loan applicants	1958 - 65							
* 1 year			Overall 10%	Type 1 22%	Type 2 5%	Overall 5%	Type 1 6%	Type 2 3%	Overall 7%
2 year			18%	34%	8%	18%	28%	6%	-
3 year			21%	36%	8%	52%	-	-	-
4 year			24%	47%	3%	71%			
5 year			22%	42%	4%	64%			
			(22%)						

* Years prior to failure. Figures in brackets represent test against hold-out sample.