

# Five Costly Mistakes That Cause Smaller Enterprises to Fail: Solutions for Success

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## ECONOMIC RELEVANCE OF SMALL AND MEDIUM-SIZED ENTERPRISES

Small and medium-sized enterprises (SMEs) account for a significant part of the gross domestic product (GDP), the total workforce, and expected growth in the next decade. Specifically, according to the Small Business Administration, there are more than 27 million privately held companies in the United States, most of them SMEs with fewer than 20 employees. SMEs employ approximately 60 million employees overall, which is close to one-third of the US population that is employed; they are projected to create more than 75 percent of the new jobs over the next ten years.<sup>1</sup>

SMEs also play a key role in international trade, as they account for a surprising 29 percent of the annual export value in the United States.

SMEs have garnered a lot of attention in the current

*Small and medium-sized enterprises play an important role in the US economy, yet they're often beset by financial woes. Financial professionals can help their executives and managers convert the vision, mission, and strategic goals of their enterprises to provide timely information; assist with pricing and cost analysis for bids or orders; and assist these enterprises with meeting regulatory requirements.*

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economic downturn, becoming a focus for political and corporate debates regarding access to capital and the cost of regulatory compliance. A common concern is that the lack of access to capital and the cost of regulatory compliance can be devastating to SMEs. They have limited resources, and their focus should be on core competencies that have a direct benefit to the economy. For example, there has been significant demand by the US Chamber of Commerce to influence the White House and Congress to relieve the strain on SMEs. The US Chamber of Commerce wants SMEs to have access to capital and a reduction in the impact of compliance and regulation from rules such as the

new IRS Form 1099 or the Sarbanes-Oxley Act of 2002 (specifically, Section 404 on internal control reporting and compliance).

SMEs benefit the economy by employing individuals, by discovering new practices that can lead to new jobs and new industries, and by creating

business efficiencies. The size of SMEs facilitates responsiveness to emerging technological practices. The pharmaceutical and media industries, for example, rely on SMEs for innovations such as new drugs or new applications. These industries often acquire or partner with SMEs to extend their future revenue stream and offerings.

More recently, the Financial Accounting Foundation, National Association of State Boards of Accountancy, and American Institute of Certified Public Accountants (AICPA) formed a Blue Ribbon Panel to identify the best way to proceed with US generally accepted accounting principles (GAAP) for SMEs. These three key organizations

believed it is now in the best interest of the country to address the ongoing concerns of the relevance and cost of complying with GAAP. GAAP are now primarily focused on publicly traded organizations, of which there are fewer than 18,000, compared with more than 27 million SMEs.

The critical role that SMEs play in the United States and the overall global economy suggests how important their ongoing success is. Yet with more than 500,000 new SMEs starting annually, more than 60 percent of them fail within two years. The goal of this article is to point out the top five reasons SMEs fail, which are outlined in Exhibit 1, and identify the essential role that financial professionals and consultants can play to resolve these issues.

## ORGANIZATION AND MANAGEMENT CATEGORIES

Both of the authors are members of the Institute of Management Accountants Small Business Committee, which seeks to advocate on behalf of its members who either work for a small business, support small businesses in their corporate role, or own a small business. Common acronyms and phrases used in these circles include *OFO* or *OEO*, which stand for “only financial officer” or “only executive officer”—which is often the case in SMEs.

### Owner as the Institution

The strength of an SME is that it does not have the organizational limitations that, in larger companies, often stifle innovation. SMEs can often respond to market changes quickly. When

the District of Columbia recently passed a law to require hands-free devices for cell phones, within days street vendors had hands-free devices for sale, before many traditional stores even had them in stock.

On the other hand, SMEs are crippled by a lack of objective opinions about ideas and a lack of expertise in key areas such as finance, inventory management, and operational management. In many SMEs, the owner is everything. Another way of put-

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a short while. If the OEO is incapacitated for a significant period of time, many businesses fail.

What can an SME do to avoid this situation? Create processes and procedures. The procedures should indicate the correct way to handle transactions and include thresholds for management approval. For commitments below a certain threshold that follows established procedures, employees should be able to complete the transaction without waiting for the OEO's approval.

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### Emotional Leadership

Emotion rules decisions. If the mood of the management determines the actions taken to satisfy customer requests, deal with employees, and interact with suppliers, the business is in trouble. People want consistency in a business. Therefore, emotional leadership not only has a negative impact on the internal environment of an SME, but it also has a negative impact on the bottom line.

When decisions are made based upon the emotions of decision makers, customers will leave. Suppliers will no longer want to deal with the SME. What can be done to avoid emotional leadership? Allow information to guide the decision-making process. One of the key missing elements of some SMEs is “management by information.” Some SMEs are very reactive, which (as noted earlier) can certainly have its benefits, but there are also several disadvantages.

ting this is that the owner has to wear many different hats. Is this a requirement for SMEs? Many executives of SMEs will state they have to do everything or else nothing will get done. That's true if they are the only ones with the authority to make decisions.

We all know someone who runs a business—and usually that person is always running around. He has to make every decision for the business. There are employees, but they have to wait on the OEO before anything can be finalized. Even if it's a transaction that is done the same way every month, the OEO has to review it and approve it. They are the owner—literally. They take ownership of everything and they can't delegate. Why is this so dangerous?

What if the OEO is hit by a bus? Will the business continue to run? The answer is usually only for

## Exhibit 1

**Five Costly Reasons SMEs Fail**

<b>Category</b>	<b>Business Failure Reasons</b>	<b>Solutions</b>
1. Owner as the Institution	<ul style="list-style-type: none"> <li>• Owner is business</li> <li>• Depending on the OEO for everything</li> <li>• Lack of processes</li> </ul>	<ul style="list-style-type: none"> <li>• Financial professionals and consultants can help SMEs develop policies and procedures that will allow processes to rule the land.</li> </ul>
2. Emotional Leadership	<ul style="list-style-type: none"> <li>• Being led by emotion</li> <li>• Lack of information</li> <li>• Inconsistency</li> <li>• Bad reputation</li> </ul>	<ul style="list-style-type: none"> <li>• Financial professionals and consultants can provide timely information that allows SME management to make decisions based upon information instead of emotion.</li> </ul>
3. Business and Industry Knowledge	<ul style="list-style-type: none"> <li>• Inadequate industry knowledge</li> <li>• Inability to explain core competencies and competitive advantage</li> <li>• Inability to effectively compete for bids</li> <li>• Inability to accurately price products or services</li> </ul>	<ul style="list-style-type: none"> <li>• Financial professionals and consultants can provide information about current market conditions and forecasted trends for the SME and its industry. They can also provide cost-analysis data necessary for accurate pricing.</li> </ul>
4. Advocacy and Politics	<ul style="list-style-type: none"> <li>• Inefficient use of funds for political involvement</li> <li>• Inability to compete financially with large institutional contributors</li> </ul>	<ul style="list-style-type: none"> <li>• Financial professionals and consultants can recommend SMEs join organizations with effective legislative and regulatory monitoring programs in place.</li> </ul>
5. Financial Management	<ul style="list-style-type: none"> <li>• Lack of long-term strategy</li> <li>• Inability to obtain large organizations as customers</li> <li>• Inability to obtain additional capital</li> </ul>	<ul style="list-style-type: none"> <li>• Financial professionals and consultants can assist SMEs in selecting the right financial systems.</li> <li>• They can also help SMEs develop an effective financial reporting and management process.</li> <li>• Financial professionals and consultants can also help SMEs in creating a long-term strategy.</li> </ul>

Managing by emotions and not information violates the key reason financial information is generated—especially management accounting information. The beginning chapters of both financial and managerial accounting courses teach that financial information supports the

decision-making process by both stakeholders and management.

Many SMEs do not have a formal process for summarizing the financial and operational results. This impairs their ability to effectively submit bids. The lack of information also prevents these businesses from effectively

managing their costs if they win a bid. As a result, quality, reliability, and (in some cases) the very existence of the business become major issues. This results in poor customer service and satisfaction, which limits the future opportunities due to a bad reference.

All businesses rely on their reputations to sell future goods and services. A bad reputation for quality and reliability will have an adverse impact on future revenue generation. The impact is even more significant for SMEs. The long-term success of SMEs is especially dependent upon their operating and managing the business based on information instead of emotion.

### Business and Industry Knowledge

During the 1990s, career coaches began recommending that professionals new and old have an elevator speech—a one-minute compelling story about who they are and what value they bring to the table. The Small Business Administration asks each company attending their various seminars to introduce what their company does, why they are unique, and their strategy and mission in one minute or less.

Amazingly, many SMEs cannot concisely convey what their enterprise does and what makes it unique or competitive. If the SME doesn't know its competitive advantage, it can't expect customers to know it.

Several SMEs neither know their industry nor their target customers as well as they should. Just as job candidates should study the industry and potential employer before an interview, SMEs should study the industry and potential customers before approaching customers. Several SMEs approach potential customers without doing their homework. As a result, they fail to expand their business, retain business, and deliver quality services.

Dennis Rodman, the controversial but very successful former NBA basketball player, often won defensive player of the year or led the league in rebounds. The key to his success was that Rodman viewed the court as a geometric object: He knew that each shot would result in a certain angle. Rodman had studied game films enough to predict the probability of where a missed shot would land, so he could position himself where he could obtain the rebound.

Like Dennis Rodman, SMEs need to position themselves for success. SMEs need to distinguish their company through their in-depth knowledge of their industries, their customers, and their environments. Cus-

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tomers like being around those who are in the know; they respect knowledge. An SME's ability to clearly explain its benefits compared to those of its competitors can lead to substantially higher revenues. An SME's inability to know and communicate the company's benefits compared to the industry will present challenges to stability and growth.

### Advocacy and Politics

In 2010, the US Supreme Court passed down a decision that bans current limits on corporate spending in the election process.<sup>2</sup> This allows corporate America the boundless opportunity to contribute to political candidates and

thus influence local, state, and federal legislative matters.

Many SMEs want to play like the big boys and play in the political arena. They will attend \$1,000-per-plate fundraisers, contribute to political action committees (PACs), or give directly to campaigns of individual candidates. This is, frankly, a poor use of funds. An SME cannot make a dent in the types of influence that companies like Microsoft, General Electric, or even foreign companies such as Airbus can have on the political process.

A more efficient and cost-effective way to obtain influence and seek advocacy is to join industry groups such as the US Chamber of Commerce and professional organizations such as the American Institute of Certified Public Accountants (AICPA). These organizations generally have separate PACs or committees that focus on regulatory monitoring and respond to emerging legislative matters as they arise. For example, these organizations commented formally

and informally to Congress about the issues related to the IRS Form 1099 in the 2010 Healthcare Act.

Instead of being a small fish in a big pond, SMEs should join a large group with a voice. For a nominal fee, an SME can join these organizations and get involved on a committee. Or an SME can join, communicate its issues and concerns regarding legislation, and allow the organization to be its advocate. Then SMEs can use already-scarce funds where they belong—in their businesses.

### Financial Management

There is value in having a financial team—whether

internally, externally, or both. A financial team can help ensure accurate, timely, and relevant generation of information to assess and evaluate the business.

This is the area where many SMEs are often not well developed, whether because of a lack of resources or a lack of appreciation for the value of effective financial management. Good financial management is necessary not only for internal monthly reporting, but also to assess a company's operations and performance. An accurate assessment of company performance requires accurate financial data.

One of the best ways to ensure accurate financial data is to have a good financial system and a competent financial professional. It's best to obtain a financial system that can handle transactions particular to your industry. Regardless of the financial system, the financial information is only as good as the data entered.

A financial expert for an SME is often a necessity rather than a luxury. SMEs cannot afford to misstate their financial performance. When growing a business, the ability to evaluate whether or not prospective business is profitable is essential to success. For example, if an SME bids based upon "gut feeling" or limited information, it may commit the company to a price that does not meet its fully burdened costs per hour for services or per product.

Potential customers develop an expected price range and, while they seek the lowest bid, they often go for what is called the best value or best realizable value. Companies often know that if a set of prices seems too low, there could be an issue with

the quality, reliability, and even continuity of the vendor offering the goods or services. Some bid evaluation committees view extremely low prices as a lack of understanding of the project or bid requirements. As a result, some of them will evaluate the vendor poorly on technical qualifications even when the original red flag was a pricing issue.

The lack of appropriate financial management systems will impair an SME's ability to obtain working capital to sustain or expand current operations.

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Stakeholders such as banks, suppliers, and leasing companies evaluate the management of an operation through Dun and Bradstreet reports and reviewed or audited financial statements. They may also conduct an office visit and ask about your ability to manage your company. They want to know that their risks will be minimized by an SME's effective use of financial management tools such as budgets and monthly performance reports. If an SME does not have reliable financial data, it will impair the SME's access to capital.

## THE ROLE OF FINANCIAL PROFESSIONALS

The failures discussed earlier—starting with the owner being an institution all the way through to a lack of adequate

financial management—can primarily be resolved by getting appropriate support from financial professionals. Financial professionals can assist an SME's owners and management to translate their vision, mission, and strategic goals into measurable annual and multiyear budgets. They can also establish key performance metrics and supporting systems to provide timely information and help SMEs with pricing and cost analysis for bids or orders, and that also assist them with regulatory compliance.

Financial professionals can assist SMEs in resolving these challenges and frequent causes of business failure. Financial professionals can serve as business advisors by navigating management through business information and assisting them with the development and maintenance of key business systems such as a financial and operational plan, a budget, and a financial system.

We recognize the limitation of financial and human capital resources for SMEs. We recommend that leaders of SMEs seek to leverage the resources of professional organizations and social media to align themselves with experts that can help ensure financial, operational, and managerial excellence. Various studies indicate that both the lack of capital and the lack of proper management of available capital are key reasons for business failure. Thus, we specifically suggest networking to identify professional accountants that possess credentials such as the CMA and CPA to provide guidance and support, to ensure effective resource allocation, and to develop appropriate reporting

systems to effectively manage limited resources.

The growth due to the economy and technology in “freelance consultants” across various disciplines allows access to “buy as you need” professional support from accounting to marketing. One of the authors uses the “cloud” for all the company’s services, from accounting to taxes to web hosting, and for more than 250 employees. This saves money, of course, but it also provides access to best-in-class resources.

When the management of SMEs fails to deploy an appropriate level of expertise within their budgetary constraints, the result can be a “do-it-yourself” management style that may be fine for low-volume and small projects, but it is not sustainable for large-scale or high-volume projects. It takes a team of experts to be successful on a

long-term basis for large-scale and high-volume projects.

It is critical that businesses develop appropriate business systems for their level of activity to generate reliable, timely, and consistent financial and operational information. The ability to use cloud-like services in accounting, technology, and legal services is available today in a cost-effective manner. Financial reporting must be performed on a consistent basis. Ideally, it should be performed by a financial professional who understands business information particular to the SME’s industry.

## CONCLUSION

SMEs are an important component of our GDP and of anyone’s plans to rebuild our economy. The five most costly failures can be resolved largely

by obtaining appropriate support from financial professionals. Financial professionals can assist SME executives and management to translate their vision, mission, and strategic goals into measurable annual and multiyear budgets. They can help SMEs establish key performance metrics and supporting systems to provide timely information; assist with pricing and cost analysis for bids or orders; and assist them to ensure that regulatory requirements are met.

## NOTES

1. Statistics for SMEs were summarized from the US Small Business Administration, [www.sba.gov](http://www.sba.gov), the US Department of Labor—Bureau of Labor Statistics, [www.bls.gov](http://www.bls.gov), and the US Department of Commerce, [www.commerce.gov](http://www.commerce.gov).
2. US Supreme Court, *Citizens United v. Federal Elections Commission* (1/21/2011), <http://www.supremecourt.gov/opinions/09pdf/08-205.pdf>.

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