

## The Causes of the Failure of New Small and Medium Enterprises in South Africa

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### Abstract

New small and medium enterprises (SMEs) are an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development. New SMEs suffer from a high failure rate in South Africa. The high failure rate of new SME paints a bleak picture of the SME sector's potential to contribute meaningfully to job creation, economic growth and poverty reduction. The primary objective of this study was to determine the causes of the failure of new SMEs. The review of the literature revealed that the causes of the failure of new SMEs are both internal and external. Internal factors include lack of management experience, lack of functional skills and poor staff training and development and poor attitudes towards customers. External factors include non-availability of a logistics chain and a high cost of distribution, competition, rising costs of doing business, lack of finance and crime.

**Keywords:** failure, causes, new SMEs, South Africa.

### 1. Introduction

The unemployment rate in South Africa is currently 25.2% (Statistics South Africa, 2014). In addition, the country experiences high levels of poverty and income inequality. Small and medium enterprises (SMEs) are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development. According to Maas and Herrington (2006) the contribution of the SME sector cannot be sustained without the creation of new SMEs. New SMEs are seen as a significant component of the solution to South Africa's development issues. The creation of a new SME is a two-stage process. The first phase is the start-up phase, a three month period during which individuals identify the products or services that the firm will trade in, access resources and put in place the necessary infrastructure such as staff. The next phase, a period of 3-42 months, is when the SME begins to trade and compete with other firms in the market place. Therefore, a new SME can be described as an SME that has being in existence for less than forty two months. Once a firm has successfully existed for more than 42 months, it becomes an established firm. In addition, a new SME in South Africa must meet the qualitative and qualitative definitions of an SME as prescribed by the National Small Business Act (Government Gazette of the Republic of South Africa, 2003).

Turton and Herrington (2013) point out that the creation rate of new SMEs in South Africa as measured by the Total Early-Stage Entrepreneurial (TEA) activity is one of the lowest in the world. South Africa's TEA rate decreased from 9.1% in 2011 to 7.3% in 2012. It is significantly below the average of efficiency-driven countries (14.3%). In addition, it is estimated that the failure rate of SMEs in South Africa is between 70% and 80% (Adeniran and Johnston, 2011). According to Adcorp (2012), around 440,000 small businesses have closed in the last five years in South Africa. In addition, the number of new business start-ups is at an all-time low. The number of small businesses in South Africa has stagnated over the past decade. Small businesses offer the only real prospect of large-scale job creation in South Africa. This is an adverse feature of South Africa's entrepreneurial sector. South Africa's high failure rate of new SME creation rate paints a bleak picture of the SME sector's potential to contribute meaningfully to job creation, economic growth and poverty reduction

Titus (2008) asserts that the significant role of SMEs in the economies of countries worldwide suggests that an understanding of why SMEs fail (or are successful) is crucial to the stability and health of the global economy. Government policymakers in most countries have been spurred on by what they see as the job generation potential of SMEs. The high incidence of failure is a serious waste of resources. There are both economic and human costs associated with the failure of new SMEs. In the light of this, it is important to understand the causes of the failure of new SMEs. Bowen et al. (2009) remark given the high failure rate of SMEs, it becomes vital to research into the factors that

are required to enable SMEs to survive and improve their performance.

## 2. Objective of the Study

New SMEs are fundamental to the growth of the South African economy and its future socio-political stability. The creation and sustainability of new SMEs are vital to the economic prosperity of South Africa. However, new SMEs suffer from a high failure rate in South Africa. The primary objective of this study is to determine the causes of the failure of new SMEs. Understanding the causes of the failure of new SMEs is of importance in improving their survival.

## 3. Literature Review

### 3.1 Why focus on new SMEs?

Puhakka (2007) suggests that research on business organisations is moving from the management of existing firms to the creation of new firms. Organising new businesses is very important because of the speed of change and the competition in the business environment. Because of unemployment and poverty, policy makers have responded to this new evidence with a new mandate to promote the creation of new SMEs. According to Wong et al. (2005), Schumpeter in 1934 was one of the earliest economists to argue for new firm creation. According to Schumpeter new firms are the vital force behind the progress of capitalism. The innovative activity of entrepreneurs feeds a creative "destruction process" by causing constant disturbances to an economic system in equilibrium, creating opportunities for economic rent. In adjusting to equilibrium, other innovations are spun-off and more entrepreneurs enter the economic system.

Hong and Daly (2005) point out that new SMEs trigger competition, stir research and development and innovation, push old firm to improve their efficiency, inject new blood into the veins of the economy and result in economic growth, technological upgrading, job creation and welfare improvement. Hiscocks (2005) argues that successful new SMEs are likely to add significant benefits to the regional and national economies. The benefits are likely to be in the form of new products, new jobs, greater exports and taxation revenues. Bruce et al. (2009) find that the number of births of new SMEs adds significantly to a country's gross domestic product. Therefore, new SMEs provide long-term benefits to the local economy. Maas and Herrington (2006) endorse the argument that new SMEs make a significant difference to economic prosperity and that South Africa risks economic stagnation without a high new SME creation rate. Countries that are able to replenish the stock of businesses and jobs and have the capacity to accommodate volatility and turbulence in the entrepreneurial sector are best placed to compete effectively. In countries ranking high in the Global Entrepreneurship Monitor (GEM) analysis, entrepreneurship and new SME creation is an integral and accepted feature of economic and personal life. Mutezo (2005) points out that about 300,000 new jobs must be created annually in South Africa, if the country is to retain its present unemployment rates, especially taking into consideration the high number of new comers into the labour market.

### 3.2 Failure of new SMEs

#### 3.2.1 Definition of SME failure

Peacock (2004) observes that there are two fundamental characteristics of new SMEs which separate them from large firms. One is their smallness, and the other is their rate of turnover and their failure rate. Peacock (2004) further notes that:

*"The chance of a newcomer becoming an established member of the business community is sadly slight. The SME owner carries on until his funds are exhausted and then disappears from the scene. His place is taken by another hopeful, certain that he has the abilities which will permit him to succeed where his predecessor has failed. .... Unaware of the odds against them, and largely ignorant of the weapons of trade, prospective proprietors march stolidly to the ambush".*

Peacock (2004) reveals that there are a number of different meanings that are attributed to the word "failure" as it applies to an SME. To the economist, this would be a firm which earned a rate of return on investment which was insufficient to cover its opportunity cost. This is however not a useful approach for most purposes because data is not often available to make the necessary calculations about the profitability of small firms. The easiest way to understand

“failure” is legal failure. This occurs when a small firm is formally liquidated or in the case of an unincorporated enterprise the owner becomes bankrupt for business reasons. An alternative approach is to relate failure to the exit rate of owners or firms from the small business sector. Yrle et al. (2000) agree that it is difficult, if not impossible to obtain sufficient reliable information to measure the performance of small firms as expressed in economic sense, such as the rate of return on capital. Therefore, empirical studies on business failure have tended to rely on some recorded events as surrogates to measure failure. The two events for which data have been most readily available are the discontinuance of a business for any reason and formal bankruptcy proceedings. Between these two extremes two further definitions have been proposed. The first definition is termination to prevent further losses and the second definition is the failure to make a go of it. In South Africa, one of the primary measures of business failure is the Statistics of Liquidations and Insolvencies published by Statistics South Africa.

Watson (2003) expands the definition of SME failure to include the following reasons: (1) Bankruptcy which is defined as discontinued operations with resulting losses to its creditors. (2) Discontinuance which is defined as prevention from further losses. (3) Not ‘making a go of it’ is the most subjective reason as it is based upon personal goals not being reached, and (4) Retirement due to bad health. Titus (2008) points out that failure occurs if a firm fails to meet its responsibilities to the stakeholders of the organization, including employees, suppliers, customers and owners. From this viewpoint, a business failure is the termination of an entrepreneurial initiative that has fallen short of its goals. In addition, failure happens when there are significant losses in the capital of the business that ultimately lead to business discontinuance. Honjo (2000) observes that a number of firms continue to trade while earning low rates of return. However, when viewed from the rate of return perspective, a business is said to have “failed” if it meets any of the following criteria: (1) Earnings Criterion: A firm has failed if its return on capital is significantly and consistently lower than that obtainable on similar investments. (2) Solvency Criterion: A firm has failed if the owner, to avoid bankruptcy or loss to creditors after such actions such as execution, foreclosure or attachment, voluntarily withdraws, leaving unpaid obligations. (3) Bankruptcy Criterion: A firm has failed if deemed to be legally bankrupt. Bankruptcy is normally accompanied by insolvency and/or liquidation. (4) Loss cutting criterion: A firm has failed if the owner disposes of the firm or its assets with losses, in order to avoid further losses.

Pretorius (2009) notes that understanding business failure presents an enormous theoretical challenge and that no one universal definition exists. The author reviewed the literature on the definitions of business failure and remarked that

*“A venture fails when it involuntarily becomes unable to attract new debt or equity funding to reverse decline; consequently, it cannot continue to operate under the current ownership and management. Failure is the endpoint at discontinuance (bankruptcy) and when it is reached, operations cease and judicial proceedings take effect”*

### 3.2.2 Causes of failure of new SMEs

Mudavanhu et al. (2011) point out that there are many reasons why small businesses fail. Pratten (2004) argues that one line of research developed by Stinchcombe (1965) suggests that the liability of newness is an important reason for the failure of new SMEs. This viewpoint proposes that new organisations fail from a combination of internal and external factors. The liability of newness framework identifies problem factors which inhibit new venture success. Internal factors are factors that are largely controllable by the organisation and include lack of management experience, lack of functional skills (e.g., planning, organizing, leading and controlling) and poor staff training and development and poor attitudes towards customers. External factors are factors largely uncontrollable by the organisation and include non-availability of a logistics chain and a high cost of distribution, competition, rising costs of doing business and a lack of finance. Pinhold (2008) declares that the liabilities of newness are substantial for a new SME. It is far more costly to win a new market than to preserve an existing one. In addition, it takes time to build up sales, whereas overhead expenses are incurred from day one.

Hiatt and Sine (2012) assert that the external and institutional environments impact on organisational outcomes. Political institutions play a fundamental role in constituting the environment in which new firms are born. The major role of political institutions is to provide stable and predictable environments necessary for the growth of economic activity. This is accomplished through the enactment of laws, the protection of private property and the enforcement of contracts, the provision of education and social welfare, the protection of personal safety and public order, and the organised armed protection against outside attack. Environments characterised by weak institutions and high levels of political and civil violence directly affect new venture survival. This suggests that the failure of new SMEs may be affected by factors such as crime, corruption, weak property rights and contract enforcements and an education system that does not promote entrepreneurship.

Another stream of research on new SME failure as pointed out by Ahmad and Seet (2009) focuses on management skills as the new small firm transits from the founding entrepreneurial stage to higher growth rate stages. A critical factor in the success of a new SME is the ability of its initial leadership to continue to meet new challenges as the business evolves. New SMEs are often begun by an entrepreneur with a very specific marketable product or idea, who then brings together other founders and funding to create the new business. Start-up firms need to augment their managerial capabilities as they grow. The development of the venture presents changing leadership needs and a need for different managerial capabilities. Entrepreneurs reach an "executive limit" at which their inability to manage the firm becomes detrimental. In such cases, ventures that do not replace the entrepreneur with a professional manager are more apt to fail. This "executive limit" concept is consistent with the internal causes of failure. Valdiserri and Wilson (2010) agree that management or leadership mistakes are one of the causes of the failure of SMEs. Some of the leading leadership mistakes that lead to business failures are: going into business for the wrong reasons, underestimating business time requirements, family pressure on time and funds, lack of market awareness, lack of financial responsibility and lack of a clear focus.

Temtime and Pansiri (2004) find that factors related to marketing such as lack of market research, ineffective demand forecasting and analysis, bad customer service, and lack of training for sales staff are the most significant factors leading to the failure of new SMEs. Bad business planning easily leads to failure. The investment analysis and working capital management factor is rated second. Customer relationship is rated third. Managerial action and external environmental factors are rated fourth. Phaladi and Thwala (2008) conclude that lack of effective management, financial management, entrepreneurial skills, proper training, resources, technical skills, contractual and managerial skills and inability to get credit from banks and suppliers are critical failure factors of SMEs. Maas and Herrington (2006) find that the primary reasons for the discontinuance of new businesses in South Africa are financial reasons, personal reasons, other reasons, too much competition, lack of customers, found another job and retirement. Mboniyane (2006) observes that the most common causes of business failure in South Africa are lack of knowledge regarding legal matters, lack of funding and a general lack of business acumen.

Pinhold (2008) argues that one of the primary reasons why new SMEs fail is their abnormal rate of creation. New SMEs are formed at a rate that is far higher than is needed by the economy. Also, individuals have complex motivations for starting a business and achieving a financial return is but one of them. Over-optimism fuels the process causing business founders to overestimate the returns and underestimate the risks involved. The resulting oversupply of new SMEs creates a necessity for a high business failure rate. According to Yrle et al. (2000), a comprehensive approach towards the failure of new SMEs should examine the causes of failure not only from the angle of entrepreneurs but also from the angle of the suppliers of capital. Yrle et al. (2000) argue that suppliers of capital such as banks and venture capitalists believe that poor management is the most important factor contributing to small firm failures. Although most entrepreneurs claim that finance is a key cause of failure, banks contend that they are willing to lend to new firms that are investment ready. Temtime and Pansiri (2004) also argue lack of finance may be a direct cause of business failure but the indirect cause which is often more important but seldom recognised by entrepreneurs is the lack of management skills. Banks and other lending organisations have adopted a set of criteria that they use to evaluate new business proposals. Robb and Fairlie (2008) also disagree with entrepreneurs that the lack of finance is the major cause of small firm failure. Robb and Fairlie (2008) compare the performance of SMEs owned by Asian immigrants and locals in the United States. The study finds that SMEs owned by Asian immigrants face limited access to external finance and are more likely to invest personal or family savings in the business. Immigrants firms however have higher survival rates, profits, employment, and sales than firms owned by locals. The most significant factor associated with the high level of success of immigrant firms is the level of education. Boeker and Wiltbank (2005) find that to entrepreneurs, the four most important factors causing failure are poor market conditions, poor capitalisation, poor management strategy and key people incompetence. To fund providers, however, the four primary causes of new SME failure are the lack of management skills, poor product design, the lack of technical skills and lastly inadequate capitalization.

### 3.2.3 *Costs and benefits of new SME failure*

Hart and Knott (2005) point out that failure has important ramifications for a number of the stakeholders involved in the start-up process. Unincorporated SMEs do not enjoy limited liability. Failure can, therefore, lead to the loss of the business and personal assets. Unincorporated SMEs are often collateralised by the personal assets of the founder. Incorporation should help limit the personal losses to entrepreneurs in the case of failure. Maas and Herrington (2006) point out that there are also emotional costs involved in new SME failure. South Africa has a harsh attitude towards failure, which inhibits many potential entrepreneurs. Hart and Knott (2005) further note that the impact of failure may also

bear on government policy. New SMEs are lauded as the engines of economies around the world. Business failures have a high cost in terms of employment, lost productivity, purchasing power (unpaid wages) and finance (unpaid debts), poverty reduction and income equality. Business failures can also lead to social problems such as crime, drunkenness and prostitution. Business failure can further lead to reduced income for the government in the form of lower taxes and increased expenditures on crime prevention.

Mitchell et al. (2008) argue that the effect of new SME failure can be portrayed both negatively and positively. While the negative effects of failure are manifest in monetary and emotional costs, its positive effects are less visible, being associated with learning, experience, and other cognitive constructs. Most lenders and venture capitalists consider a previous failure to be a virtue of finance seeking entrepreneurs. The meaning of new SME failure must at least be interpreted within the context of start-up experience. Failure can actually facilitate experience and a new beginning leading to success. This is consistent with the view of Markman et al. (2007) that personal perseverance is related to a person's capability to persist in the face of difficulties, risks, and failure. Such persons consistently rise up and break through and as they persevere, they become more skilled and empowered to tackle the next adversity. Social cognitive theory proposes that since different individuals tend to sustain different levels of adversity, personal success is the degree to which individuals move forward and upward despite what appears to be insurmountable obstacles and other forms of adversity.

Peacock (2004) reports that the total proportion of businesses in the economy which are small tends to be stable and that a high closure (failure) rate is consistent with competition and vitality - *'for every failure, a new small business is established ... there are .....benefits arising from the elimination of less successful firms which make room for new entrants with fresh ideas.....'*. People who fail in one business may learn from their mistakes in future ventures. This suggests that business failure is a good learning curve for entrepreneurs and also brings innovation as new entrepreneurs will examine the causes of earlier business failures and look for ways to avoid them.

#### 4. Conclusions

The failure rate of new SMEs is very high in South Africa. The high failure rate negatively impacts on the ability of new SMEs to contribute meaningfully to job creation, economic growth and more equal income distribution in South Africa. The literature revealed that there are many reasons for small business failure. Failure factors are both internal and external. Internal factors are factors that are largely controllable by the organisation and include lack of management experience, lack of functional skills (e.g., planning, organizing, leading and controlling) and poor staff training and development and poor attitudes towards customers. External factors are factors largely uncontrollable by the organisation and include non-availability of a logistics chain and a high cost of distribution, competition, rising costs of doing business, lack of finance and crime. There is the need for personal development by the owners of new SMEs especially in the area of business management skills through training. Owners of new SMEs have to take greater responsibility for their own learning. Therefore, they need to create a positive attitude towards entrepreneurship and training. Government agencies such as the Small Enterprise Development should organise training for new SMEs owners on how to prepare business plans and business management. Awareness should be created for the training programmes through advertisements in local and national media. Furthermore, a "learning from peers" or mentorship approach can be instituted by government agencies to help new SMEs. New SMEs should look at using non-executives at an early stage to bring external expertise and guide investment decisions. There is also a need for a well-publicized educational campaign against crime. More effective policing is needed, including better police visibility, area coverage and faster response times.

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