DOI: https://doi.org/10.3126/pycnjm.v3i1.81798

Analyzing Perceived Causes of Business Failure: A Factor Analytic Approach

Rabindra Joshi

Abstract : *This paper analyzes respondents view through a questionnaire survey on the perceived causes of business failure in the context of Nepal. From the results of the survey conducted, it is observed that the most serious problem of sickness in firms can be condensed into three main categories, viz., managerial, financial and economic. The study thus provides support for the causes of firms' sickness that can be categorized into three fundamental problems: Inaccessibility to debt, the lack of knowledge of the owner/manager, and the business climate. The sick firms have found these three problems most impelling for their failure.*

I. INTRODUCTION

A general view of business failure is that it results from a mismatch between the current available liquid assets and its current obligations (John 1993). Business failure does not necessarily result in the collapse and dissolution of a firm. In an economic sense, it could mean that a firm is losing money. Its revenues do not cover its costs. It could also mean that its earnings rate is less than its cost of capital (Weston & Copeland 1992). It means the firm's actual cash flows are below its expected cash flows and its projections have not been met. Thus, business failure may be viewed in a variety of ways. There are various reasons for any firm being driven towards business failure. Some of these reasons are government policy, recessionary trends, natural calamities, scarcity of raw materials and power, lack of good governance, poor implementation, marketing problems, shortage of working capital, labor trouble and so on. Before a healthy firm goes really bankrupt, it will first provide some signals and symptoms of financial distress. Signals of financial distress tend to start with short-term liquidity problems followed

Mr. Joshi is a Faculty Member at Central Department of Management, Tribhuvan University. He can be reached at joshirabin2003@yahoo.com

(This paper is originally presented at the "International Seminar on Management" on "Enhancing Enterprise Effectiveness for Global Challenges" organised by Brihaspati College, Siddharthnagar on 3rd and 4th April 2010. The author acknowledges that the printed version of the paper has come after the suggestions from the Editorial Committee.)

by operating losses, excessive use of external debt and inability to meet obligations. Gradually, these signals will emerge into symptoms which may be reflected in continuous decline in market price of shares, shortage of cash, decline in liquidity, profitability, and turnover and other financial ratios, default in payment of materials, wages and salaries, interests and so on.

Business failure identification is now widely used for range of purposes, including monitor the solvency of financial and other institutions by regulators. Business failure has been viewed in various ways. One point of view is that it is technical insolvency; others consider it to be real insolvency where the liabilities of a firm exceed assets. Sometimes it is specified in the strictly legal sense of bankruptcy or liquidation while at other times a firm is taken to be in failure when it begins to incur cash losses leading to the erosion of funds. A firm is regarded as a failure firm when it is not likely to continue its operations or pay dividends to its shareholders or pay wages and salaries to its employees. Instead of business failure, this study has used bankruptcy to refer the business failure in Nepalese context. Thus, corporate failure, corporate bankruptcy, and financial distress have been used interchangeably in this study.

Nepal is facing various problems in recent years such as economic crises, the political instability and conflicts, which have caused operating loss directly or indirectly to number of small and large businesses. Political instability is not only the reason for the business failure, but also lack of efficient management, lack of resources, lack of visions, government policy, lack of technical knowledge, attitude of management, lack of financial analysis and planning. Thus, the paper attempts to determine the respondent viewpoint to analyze on the perceived causes of business failure in Nepal.

The paper is organized in four main sections. Section 1 introduces the topic and states the purpose of the study. Section 2 summarizes a short review of earlier empirical studies regarding value added. Section 3 outlines the methodology employed and describes the data used. Section 4 presents the empirical results. Finally, Section 5 concludes the paper.

II. EARLIER EMPIRICAL STUDIES

This section attempts to review papers authored by different researchers and authors in the area of the early indicators of business failure and perceived causes of business failure. The early indicator of business failure is formulated on the basis of those empirical works of respondent view on business failure. Financial ratios have been extensively used by different interest groups such as credit lenders, credit rating agencies, investors and management of the respective company. However, financial ratios can be perceived important in decision-making process. Generally, ratios are used to reveal financial strengths and weakness of a firm. The use of financial ratios in the area of prediction of business failure has been increased after Beaver (1968) and Altman (1968) study. A number of empirical studies have been conducted on the predictive power of financial ratios (Patrick, 1932; Deakin 1972; Ohlson, 1980). These studies attempted to

predict the early warning indicator using financial ratios.

The recent studies provide the relevant information that can be used current insight into business failure. Early studies report firm failure rates ranging from almost one half of all new firms within a year of launch almost one third within four years of launch (Copper, Dunkelberg, and Woo 1988). Headd (2003) found firms with fewer resources are more likely to fail than those with more resources. Owners with previous business ownership, firms with multiple owners, and companies maintained low overhead costs were less likely to fail than other firms. The likelihood of failure was also found to be associated with the manager and owner's work experience prior business. Boden and Nucci (2000) revealed that business where the owners had 10 or more years of college were less likely to fail. Sullivan, Warren and Westbrook (1999) found that the most common reason for failures were outside external condition, financing problems, and internal business situation. Zacharakis, Meyer and DeCastro (1999) revealed that entrepreneurs and venture capitalists had different perspective on reasons for failure. Entrepreneurs attributed failure to issues that were internal to the firm, such as lack of skill or poor strategic planning, while venture capitalists attributed failure to factors external to the firm, such as market condition.

Lack of startup capital and lack of work experience among the owners have also cited as common causes of business failure (Headd 2003). Gaskill, Van Auken and Manning (1993) found that firm failure was result of poor skills among owners, weak external business environment, poor financial management, issues related to growth, and poor management operations. Hall (1992) also found that the most prevalent reason for failure was due to operational problems and undercapitalization.

III. METHODOLOGY

The study uses primary data collected through the questionnaire survey. The questionnaire was developed and presented in January 2008. The questionnaire was based on previous research on failure identification, including Headd (2003) and Gaskill, Van Auken, and Manning (1993). The two part questionnaire was distributed. The first section of the questionnaire mainly contained background information of respondents and the second section asked respondents to rank the importance of 25 potential business problem relative to impact on sick or healthier firms which the study refer to as the impact variable. The main objective of this survey is to know the perceived causes of business failure. This study verifies how far these results are consistent with findings of previous studies.

The questionnaires were distributed to 300 respondents from 15 sample firms including 5 sick and 10 non-sick firms. Firms were categorizes as a sick and non-sick on the basis of continuous decline in market price of shares, shortage of cash, decline in liquidity, profitability, turnover, net worth, default in payment of materials, wages, salaries, interests and so on. Total 145 usable questionnaires were obtained with 46.67 percent response rate. The response rate can be regard as good when considered the

closed nature of study in other country. The judgment on causes of business failure is differs from respondent to another. The consensus approach has been conducted to test the support or deviate with three hypotheses.

Respondent were asked to rank the importance of problem in determine their success or failure using 1-7 Likert scale (1 unimportant and 7 = very important). Factor analysis was used to organize the dimensionality of 25 impact questions into independent meaningful categories. The advantage of using factor analysis is its ability to categorize the potential problems into root causes. The study is able to untangle associations among the questions and condense them into small number of components that can be used for interpretation of for further analysis.

Research Outline and Testable Hypothesis

It is clear that many researchers, author; practitioners have used the concept of perceived causes of business failure in different studies. This emergence of different concept has improved the more literature on the subject of business failure over time. In general, previous work indicates the cases of firm's sickness can be organized into three categories.

a. Characteristic of the owner and management
b. External market
c. Accessibility to capital

The study examines the sample of sick and non-sick firms and the evidence of which suggests that the firms more likely to sick have limited access to capital than the firms that are not likely to be sick. Moreover, the owners of sick firms have less experience and less knowledge, and they face limited and deteriorating markets. The study center the analysis around three testable hypotheses motivated by the studies described above.

H1: Firms with less sophisticated owner/managers are more likely to failure than other firm.

H2: Firms facing limited or deteriorating markets are more likely to failure than other firms.

H3: Firms with less access to capital are more likely to failure than other firms.

IV. EMPIRICAL ANALYSIS

Respondents' profile

The first part of the questionnaire was devoted to obtaining background information of respondents surveyed. The responses to these questions are presented in table 1. The questionnaires were distributed to different respondent of sample firms to be conscious of their opinion regarding perceived causes of business failure. This primary survey strives to explain difference opinion of these respondents on their perceived causes of business failure. The following information and table consists of detailed profile of respondents.

Table 1 : Background Information of Respondents

Variables	Number	Percentage	Variables	Number	Percentage
Gender			**Age**		
Male	100	69	Below 25	57	39.3
Female	45	31	25-50	82	56.6
			Above 50	6	4.1
Total	**145**	**100**	**Total**	**145**	**100**
Experience			**Education**		
1 year or less	18	12	Ph.D.	2	1.4
2 to 5	78	54	Postgraduate	78	53.8
6 to 10	32	22	Graduate	48	33.1
11 to 15	9	6	Undergraduate	17	11.7
Over 15	8	6			
Total	**145**	**100**	**Total**	**145**	**100**

- **Sex:** Among the respondents, 100 (69 percent) were male and 45 (31 percent) female.
- **Age:** The number of respondents by age group were found as 57 (39.3 percent) were below 25 years, 82 (56.6 percent) between 25 to 50 years and 6 (4.1 percent) above 50 years.

As an evident from table 1, the majority of person responding to the survey (54 percent) reported working career of two to five years and second largest percentage (22 percent) has a working career of six to ten years, and followed by one or less than one year working experience, 11-15 years working experience and over 15 years working experience were 12 percent, 6 percent and 6 percent respectively. As regards educational level of respondents, the majority of person responding to the survey (53.85 percent) holds the postgraduate degree but there are also good number holding the degree of graduate (33.1%), undergraduate (11.7%) and Ph.D. (1.4%).

As an evident from table-2, fifteen firms are taken as a sample including 5 sick and 10 healthier firms. The largest number, 18 respondents are from Nepal Investment Bank Ltd. and the lowest number of respondents from Dabur Nepal Ltd. The largest percentage (64.83) of respondent is from healthier firms and rest (35.17) from sick firm. The majority of person responding to the survey reported from banking industry with 46.90 percent of total respondent and followed by hotel and manufacturing industry with 23.46 and 13.1 percent respectively. In this way, there are 100 respondents from listed firm in Nepal Stock Exchange and rest from unlisted firm.

Factor analysis

Factor analysis is a statistical technique used for reducing the dimensionality of problem by summarizing a set of variables as a smaller set of inherent common factors.

Table 2 : Number of Respondents from Sample Firms

S. N.	Name of Companies	No. of Respondents	Classi-fication	Firm	No. of respondents	Percent
1	Bottlers Nepal Ltd.	12	H	Seek	51	35.17
2	Salt Trading Corporation Ltd.	7	H	Healthier	94	64.83
3	Bishal Bazar Company Ltd.	5	H		**145**	**100**
4	Yak and Yeti Hotel Ltd.	10	S			
5	Soltte Hotel Ltd.	8	H	**Industries**		
6	Taragaun Regency Hotel Ltd.	9	S	Manufacturing	19	13.10
7	Unilever Nepal Ltd.	4	H	Banking	68	46.90
8	Radision Hotel Ltd.	7	S	Trading	12	8.27
9	Dabur Nepal Ltd.	3	H	Hotel	34	23.46
10	Standard Chartered Bank Nepal Ltd.	11	H	Others	12	8.27
11	Nabil Bank Ltd.	14	H		**145**	**100**
12	Nepal Investment Bank Ltd.	18	H			
13	Nepal Bank Ltd.	12	S	**Firm**		
14	Nepal Banijya Bank Ltd.	13	S	Listed Firm	100	68.96
15	Nepal Telecom	12	H	Unlisted Firm	45	31.04
	Total	**145**			**145**	**100**

H= Healthier S=Sick

This analysis decomposes the variation in multivariate data set into a set of components such that the first component accounts for largest proportion of the variation in data, second component accounted for second largest proportion of the variation in data, and so on. In addition, each component is uncorrelated with others, which is useful property because it means that the components are presenting different dimensions in the data.

Table 3 : KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy		0.617
Bartlett's Test of Sphericity	Approx. Chi-Square	407.469
	df	105
	Sig.	0.000

The value under the Kaiser –Myer – Olkin (KMO) ranges between zero to one. For a good factor analysis the minimum suggested value should be 0.6 (according to Tabackhnick and Fidell 1996). The Bartlett's test of sphercity should be significant at 5 percent level of significance. As far as our case is concerned the KMO is above the minimum range (0.617). Thus, it can be suggested for further analysis. Here, P value under Bartlett's test is significant (0.000 < 0.05).

Three variables have eigenvalues more than one, therefore from the above analysis it has been identified three principal component and they explain around seventy percent of the total variation in the given data. Three different compartments in component matrix table depict three different dimensions of managerial, economic and financial.

Table 4 : Factoring of 25 Impact Variables for Sick and Healthy Firms

Variables	Factor 1 Managerial	Factor 2 Economic	Factor 3 Financial
1. Poor cash flow			0.907
2. High operating expenses			0.835
3. High cost of borrowing			
4. High debt			
5. Availability of equity capital for business			0.719
6. General economic condition		0.624	
7. Political inference		0.533	
8. Weak managerial leadership	0.526		
9. Government policy		0.695	
10. Lack of specific target market	0.565		
11. Lack of long term business plan	0.679		
12. Poor financial record	0.504		
13. Lack of managerial skill	0.687		
14. Inefficiency and overstaffing			
15. Ineffective planning and implementation			-0.517
16. Availability of business loan/fund		0.507	0.707
17. Rapid growth			
18. Lack of knowledge about pricing	0.713		
19. Fraud			
20. Inadequate sale			
21. Poor economy		0.743	
22. Difficult competitive conditions		0.694	
23. Ineffective promotional strategy			
24. Inventories difficulties	0.752		
25. Problem with supplier			

Eigenvalue	% of variance	Cumulative
5.242	34.97	34.97
3.95	26.33	61.30
1.38	9.25	70.55

Loading above 0.50 are included in each factor

The table 4 shows the results of a principal factor analysis with an orthogonal varimax rotation for 25 impact variable of firms regarding business failure. The loading of greater than 0.50 were considered on factor grouping. An examination of eigenvalues suggests that including any more than one in three factors only provide a marginal benefit in explaining variance. The intent of organizing the responses to the 25 impact variables into small number of meaningful groupings is to reduce the comprehensive information into general themes. Those loadings that fit each factor are highlighted in above table.

The analysis provides support for three testable hypotheses encompassing reason for business failure.

H_1: Firms with less sophisticated owner/managers are more likely to sickness than other firm.

Impact variables in factor 1, Managerial which is relating to knowledge of manager/ owner include problems with weak managerial leadership, lack of long term business plan, poor financial record, lack of managerial skill, lack of knowledge about pricing. This is also a theme that has been associated with business failure in previous study (Gaskill, Van Auken, and Manning 1993 and Perry 2001). The availability of information is critically important for good decisions in all aspect of business operation. The lack of knowledge or poor information would leads to ineffective and costly decision that result in financial hardship and firm's sickness. Therefore, this impact variable supports the hypothesis H1.

H_2: Firms facing limited or deteriorating markets and economic condition are more likely to failure than other firms.

Impact variables in factor 2, Economic, which include general economic condition, political inference, government policy, poor economy, difficult competitive conditions, are consistently related to the economic climate in which the firm was operating. The economic climates have a direct impact on revenues and cash flows, especially during slow economic period. A poor economic period would present firm with the greatest challenge because the revenue would be depressed. Therefore, the facts support the hypothesis H2.

H_3: Firms with less access to capital are more likely to failure than other firms.

The impact variables in factor 3, financial component includes problem with poor cash flow, high operating expenses, availability of equity capital for business, availability of business loan/fund. These variables are consistently associated with issues related to capital, and, debt. Issues related to debt in capital structure have been a common argument in previous business failure study (Headd 2003, Hall 1992). Debt in the capital structure can directly affect business liquidity. Large amount of debt can burden the firm with higher interest payment and cash flow problems. The inability of firms to acquire sufficient debt can also result in inadequate levels of capital to support operations. Therefore, the verification supports the hypothesis H3.

VI. CONCLUSION

The paper focuses on to determine the respondent viewpoint to analyze on the perceived causes of business failure in the context of Nepal. It was seen that a factor analysis clusters potential problem areas or impact variables into three categories managerial, economic and financial according to importance. From the analysis, the causes of firm sickness can be compact into three fundamental problems: Inaccessibility to debt (financial), the lack of knowledge of the owner/manager (managerial) and the business climate (economic). The sick firms are found these three problems most important in their failure, the study ascertains it to support H_1, H_2 and H_3.

REFERENCES

Altman, Edward I. (1968). "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy". *Journal of Finance*, Vol.23, No. 4, 589-609.

Copper, Dunkelberg, and Woo (1988). Survival and Failure: A Longitudinal Study. Wellesley, MA: Frontiers of Entrepreneurship Research, Babson College.

Beaver, W.H. (1966). "Financial ratios as predictors of failures: Empirical Research in Accounting Selected Studies". *Journal of Accounting Research*, Vol. 4, 71-127.

Boden, R., and A. Nucci (2000). "On the survival prospects of men's and women's new business ventures". *Journal of Business Venturing* ,15(4), 347-362.

Deakin, E. B. (1972). "A discriminant analysis of predictors of failure". J*ournal of Accounting Research*, Vol.1, No.10, 167-179.

Gaskill, L., H. Van Auken, and R. Manning (1993). On SBA- Guaranteed lending and economic growth. Working paper, Federal Reserve Bank of Cleveland, April.

Hall, G. (1992). "Reasons for insolvency among small firms: A review and fresh evidence". *Small Business Economics*, Vol-4(3), 237-250.

Headd, B. (2003)."Redefining business success: Distinguishing between closure and failure". *Small Business Economics*, Vol. 21, 51-61.

John, Teresa A. (1993). "Accounting measures of corporate liquidity, leverage and costs of financial distress". *Financial Management*, vol. 22, 91-100.

Ohlson, James A. (1980). "Financial ratios and the probabilistic prediction of bankruptcy". *Journal of Accounting Research*, 109-131.

Patrick P.J. (1932). A comparison of ratios of successful industrial enterprises with those of failed firms, Certified Public Accountant.

Pradhan, Radhe S. (1994). *Financial management practices in Nepa*l. New Delhi: Vikash Publishing House Pvt. Ltd.

Richard C., H. Van Auken (2006). "Small firm bankruptcy". *Journal of Small Business Management*, Vol-44(4), 493-512.

Sullivan,T., E. Warren, and J. Westbrook (1999). Financial Difficulties of Small Business and Reasons for Their Failure. Springfield, VA: National Technical Information Service.

Weston , Fres J., Copland , Thomas E. (1992). *Essential of Managerial Finance*. Chicago : The Dryden Press.

Zacharakis, A., G. Meyer, and J. DeCastro (1999). "Differing perception of new venture failure: A matched exploratory study of venture capitalists and entrepreneurs". *Journal of Small Business Management*, 37 (3), 1-14.