Top Reasons Why Small Businesses Fail

How to avoid the same fate!

LauzenAccounting

Supporting Small Business Success

Chapters

Introduction

There are many reasons why small businesses fail. You'll notice a common thread as you read each of the failure reasons. Most of them are the result of business managers getting away from working on their core business.

Think back to when you started your business. What was your primary reason for making the leap? Most people start a business because they are good at, and enjoy, offering a specific product or service. As a business grows, the founding team members often get sucked into doing operations related tasks. The business owner takes on these tasks even though they may have never done them before and have little to no expertise in that particular area. Accounting and legal related tasks are two examples.

As you'll read in this book, some things are better left to the experts. Failing because of a lack of these skills is really unfortunate because resources are available at reasonable prices to help you through these struggles.

In this eBook, we review the most common reasons for failure and what you can do, as a small business owner, to avoid these common mistakes.

Chapter 1:
Poor Financial Systems

It's easy to get so caught up in the production side of your new small business that you forget the importance of developing a solid financial system. It's just as easy to get overwhelmed by accounting processes that you fail to dedicate the time needed to do whatever made you decide to go into business in the first place. There's often a fine balance between not enough and too much when it comes to managing your small business financial systems.

First, let's talk about what your financial system ***should not*** look like. You know that documentation is an important part of managing a small business. It's tempting to set paperwork aside, allowing it to accumulate. This can cause serious difficulties. If a portion of each week (or even each day) is not dedicated to managing your finances, things can quickly become chaotic. You won't find shoe boxes filled with receipts and old invoices filling the back room of successful small businesses.

Today, developing your own functioning financial system or outsourcing the management of your finances to a trusted accounting firm is easier than it s ever been. The system you choose will depend on several factors.

Expertise Level

Who will be managing your financial systems? If you're working solo, your needs will be different than someone who has an in-house bookkeeper. Many small businesses utilize customized or out-of-the-box financial software programs like QuickBooks, Quicken or Peachtree. This may or may not be the solution for your business. If you, or someone who works for you, has some experience managing financial systems, utilizing those skills to tailor a system that makes sense for your business is certainly an option.

But it's not enough to just buy a software package. Investing in expensive financial software that's never used won't benefit your business. When researching financial software, take the time to read reviews. Many programs offer demos. This can be a good way to test the capabilities of a system and see if it fits your skill level.

As your business grows, consider hiring an accounting professional or firm with experience working with small businesses. Accounting professionals will guide you through complex issues like taxes, audits, and business planning. An experienced accountant will help you avoid common financial mistakes which can lead to business failure.

Business Type

If you run a cupcake bakery, your financial system will look different than that of someone who runs a technology startup. Things get trickier when special taxing and licensing requirements must be factored in. Here's where an experienced accounting firm can really help you. If you need to produce complicated invoices or are subject to certain laws or practices, a customized solution that is managed by professional accountants might work better for you. The benefit of working with a company to develop a customized system is the support you'll receive. You'll no longer need to get lost in the weeds of your finances. This enables you to spend more time working on, and growing, your business.

Leveraging customized software systems can be a viable option. Companies that develop software for small businesses have extensive experience with the financial intricacies that often accompany development of a workable system. Explore online communities for your business type and note which systems have worked best for businesses like yours. More on that below.

Business Size

In some cases, small businesses are run by sole proprietors; in other cases, several employees are needed to manage operations. If you're a sole proprietor, an inexpensive program like Zoho Books, or even a free program, like Mint, may be all that you need. When payroll is involved, you should either outsource payroll management to an accounting firm or consider purchasing a software package like QuickBooks, which will allow you to track your profits and expenses as well as distribute financial reports. If you don't want to get bogged down with implementing software applications, outsourcing to an accounting firm is your best bet. Accounting firm offer payroll management services for about the same price you'd pay for accounting software.

Tracking the financial data for your small business is a critical management process. Without accurate financial reports, it's impossible to know where you stand and communicate this to others. If you are even considering reaching out to lenders or investors, instant access to financial reports is a must. Your reports will also help you manage your cash flow and make filing your taxes easier.

Chapter 2:
Not having accurate and timely financial statements

Tracking financial data for your small business is a critical management process. Without accurate financial reports, it's impossible to know where you stand and communicate this to others. Many business owners simply hate doing their finances. In fact, in a recent survey 40% said bookkeeping and taxes are the worst part of owning a business. But if you are even considering reaching out to lenders or investors, instant access to financial reports is a must. Your reports will also help you manage your cash flow and make filing your taxes easier.

1 Source: http://www.prnewswire.com/news-releases/new-infographic-the-burden-of-small-business-accounting-taxes-and-payroll-300026479.html

Common Financial Reports

- ***Balance Sheet:*** This report, in its most simple form, provides a breakdown of your assets and liabilities to determine your equity. This sounds quite simplistic, and it can be, but providing a certain level of detail is important.
- ***Profit and Loss (P&L) Statement:*** This report outlines your sales and subtracting your expenses from your sales will determine your net profit. The review of this report will help you to identify trends and project your future profits and expenses
- ***Cash Flow:*** It's important to understand what cash and assets that you have on-hand and how your cash is being spent. Your cash flow report will demonstrate how cash flows into and out of your organization.
- Depending on the size and scope of your business, you might run additional reports that summarize more detailed processes such as payroll, inventory, and accounts payable and receivable.

As your business grows, you'll need to move beyond the basics. You'll need to share, through reporting, not only where you've been, but where you're going. Small businesses that do not maintain accurate and timely financial reports run a huge risk. Not only can this lead to miscalculation of business expenses, it can lead to inaccurate tax filings. Late fees and fines are preventable, but common and can lead to business failure. Roughly 40% of small businesses incur an average of $845 a year in IRS penalties[2].

Some small businesses can run necessary reports using small business accounting software or by tracking financial data through the management of spreadsheets. Those with more complex financial situations might require the assistance of a financial professional or accounting firm. Experienced financial professionals can create and manage reports that are appropriate for your small business.

2 Source: http://www.familybusinessinstitute.com/index.php/Succession-Planning/

Chapter 3: Not Understanding Financial Statements

Many new small business owners fall into the trap of taking on all aspects of managing a growing business. This isn't always the wisest decision. While this is a common mistake, it almost always is a fatal one... No one person can be an expert at all things and it's perfectly acceptable to trust certain aspects of your business management to a professional so that you can expend your time and energy on big picture issues.

As a business grows, its finances become more complex. Small businesses with and without employees are subject to certain laws and regulations, which is why it's important to have someone on your team who thoroughly understands intricate financial reports.

When a financial report is misread, it can lead to inappropriate budgeting, a false sense of security, tax issues, and even fraud. Many of these errors are preventable. This is why it is so vital to work with a financial professional or accounting firm when managing a small business. Here are some financial statements that are commonly misunderstood.

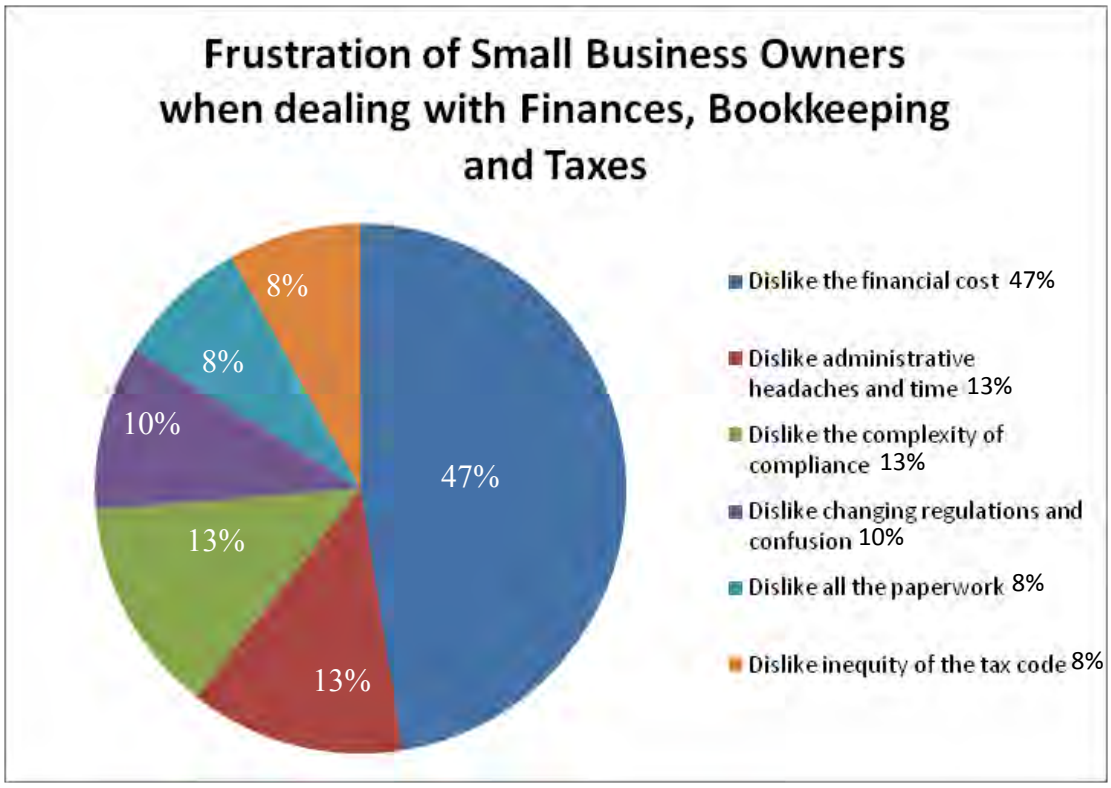
- **Tax Documents:** Paying your taxes correctly and on time is not only important, it's the law. In addition to annual income taxes, your business may be subject to payroll and sales taxes. An experienced financial professional will help you to understand your tax obligations, utilize strategies to assist you with the reduction of your tax burden and accurately report your income and expenses to the government.
- **Bank and Credit Card Statements**: Growing businesses often receive bank and credit card statements that are lengthy and complicated. Understanding your bank and credit card statements can help you to control your debt and minimize your interest expenses.
- **Budgets:** When all is said and done, budget documents are projections, and should therefore be fluid based on your business' ebbs and flows. Misreading a budget, or not understanding how to track variances, can lead to improper cash flow that cripple your business' finances.

Accurate and timely financial reports are the key to making sound business decisions. Successful business owners keep their financial reports on file, ready to be reviewed at a moment's notice. Understanding how to read these reports can help you to identify financial problems and get them under control before they ruin your business.

Chapter 4: Poor cash flow and Money Management

Many would argue that cash flow is one of the most important focus areas for small business owners. Cash on hand is the amount of cash that is available to you at any given time. Some small businesses also have access to additional cash through bank lines of credit or other sources.

Cash flow issues can result from lawsuits, natural disasters, internal or external theft, market/supply issues, competitors, the loss of a key customer, or simply a slow season. Even if you have ample credit, maintaining a cash reserve might be the best bet for getting you through the lean times. Relying on credit can lead to hefty interest charges, leaving your small business in a trickier situation than it was in to begin with.



Even when your business is profitable, you can still run into unexpected expenses. A slow month can cause you to dip into a line of credit or your cash reserves, leaving your business ill-prepared when the unexpected does arise.

To determine your ideal cash on hand figure, you'll first need to understand your cash flow. To do this, you'll need to thoroughly understand your operating costs. Some of your costs will be fixed, like rent, and some variable, like staff wages. Some expenses occur monthly, some quarterly, and so on. A financial professional can assist with this process and help you to build a reasonable estimate of your monthly costs.

There's no set formula for how much cash your business should have on hand, though most financial professionals agree that three to six months is ideal. The following factors will help you to determine how much cash your business should have in its reserve fund.

- **Business Size:** Payroll is a major expense which should be considered when determining how much cash should be kept on hand. A sole proprietor would have different needs from a business owner with four employees.
- **Type of Business:** Whether your business sells products or a service has a great deal to do with how much cash you'll need to have on hand. Cost of inventory can factor heavily into your determination.
- **Credit Availability**: Having access to tools like a line of credit can be invaluable to small business owners. The less credit you have, the more cash you'll need in reserve. Building your cash reserve is a priority for small businesses. Expansion and reinvestment in your business is important, but before this is considered, you should first have your eme gency reserves in place.

To increase cash flow, many small businesses offer discounts to regular customers, or require deposits to minimize the risk of non-payment. It's also vital to ensure that your expenses are in line with your income.

A financial professional can help you to put together a strategy so that you can determine which debt you should pay off first, and where your target cash point should sit. You'll need to take into account your business's highs and lows, along with any trends that could affect your cash flow. Business trends may or may not be in your control. Supply and demand, the local economy and even national financial issues can all impact your bottom line.

Once you've set your target, do not touch these funds until you've reached this target, unless absolutely necessary. This sounds simple, but in practice, it's not so easy. Dipping into your cash cushion, even occasionally, can add up quickly and lead to reliance on the fund for everyday expenses. This is where a financial professional can really make a difference to your small business. Understanding priorities and making choices that support your business goals is easier when you have a solid financial game plan in place

Once you reach your cash target, you'll be able to reinvest excess funds into marketing projects, new products, upgraded facilities or new staff.

Chapter 5: Not doing a good job of separating business vs. personal expenses

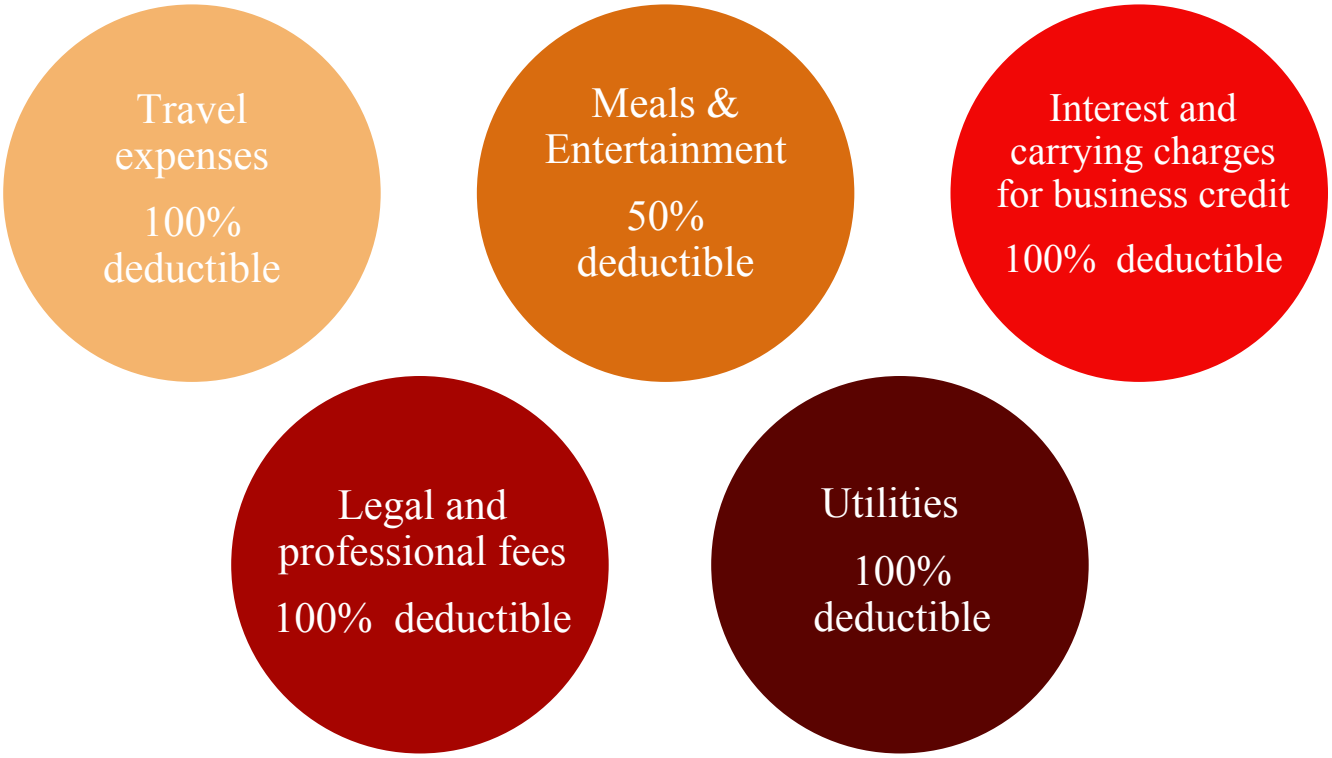
From day one, small business expenses should be kept separate from personal expenses. Failure to differentiate your business from personal expenses can cause record keeping to get scrambled, creating damage that's tough to repair.

Maintaining separate financial records for personal and business expenses makes your business look more professional in the eyes of your vendors and potential lenders. It can also save you money in the long run. Certain expenses are tax deductible, particularly if you run any portion of your business from your home.

Tips for keeping your expenses separated:

- Maintain separate accounts or your small business. Most banks and credit unions offer free or low-cost business checking and savings accounts. Having separate credit and/or debit accounts is also advisable. Paying either your personal or business debt with the wrong account can lead to an accounting nightmare.
- Keep all of your receipts separate. A separate filing system should be created for all of your business receipts. If you are unsure if an expense is personal or business-related, consult a financial professional.
- Pay yourself a set salary and stick to it. This will keep you from being tempted to dip into your small business account to pay for personal expenses.
- Create a firm budget for your small business and follow it. Budgets keep business owners accountable and prevent unnecessary expenses.

Business expense types:



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Successful business owners understand the difference between business and personal expenses. Working with a financial professional will help you to gain this understanding and ensure that you do not misclassify any of your expenses. Commonly misclassified expenses include:

- Mileage and related vehicle expenses. If you are using your personal vehicle for business purposes, it is especially important to keep detailed mileage records. Receipts for expenses such as oil changes and repairs should also be filed properly.
- Home office expenses. If you operate your business out of your home, even part of the time, some of these expenses might be classified as business expenses. These expenses might include things like utility costs.
- Charitable donations. Funds personally given to charity should be classified differently than those given on behalf of a business. In some cases, advertising or promotion of some type is offered in exchange, making it a sponsorship. This means that only a portion of the gift may be tax deductible.
- Business supplies. From software to furniture, supply costs might be classified as business or personal and the two can be easily confused.

Tax Concerns:

The IRS requires that you keep your personal and small business expenses separate. Co-mingling your expenses can lead to serious tax penalties, unnecessary fees and the eventual ruin of your business.

Maintaining a clear, easy to follow audit trail will make it easier to correctly file your taxes. Keep in mind that your business structure can impact your personal tax liability. Even if you file your personal taxes on an annual basis, your small business might be subject to different regulations.

IRS regulations can be difficult to wade through, even for the most financially savvy small business owners. When the IRS spots a business expense that is paid for with a personal account, this can raise a red flag. Relying on a financial professional to assist you with expense separation can keep your small business from dealing with needless tax hassles.

Chapter 6:
Not paying payroll taxes

When growing a small business, keeping up to date with your payroll taxes might be an afterthought. It's easy to forget this expense. The Federal Government does not treat this oversight lightly and will go to great lengths to collect what is owed.

Small businesses with numerous employees can accumulate payroll tax debt quickly and the consequence for non-payment is enormous. Failure to cover payroll taxes can even lead to criminal charges. Staying current with payroll tax laws can be overwhelming, which is why many small business owners rely on financial professionals or accounting firms for payroll tax support

Payroll Taxes:

Any business with employees is required to withhold payroll taxes from each of their paychecks, along with paying any state and local taxes. These taxes generally include FICA, or Medicare and Social Security taxes, along with Federal, State and local income taxes. Certain States have State-specific tax laws which require employers to withhold additional payroll taxes.

Even if your small business does not have employees, it may still be subject to payroll taxes, based on the type of business you operate. Sole proprietors may be obligated to pay quarterly self-employment taxes. A financial professional can explain these obligations and develop a strategy to ensure that you meet all of your tax obligations in a timely manner.

As a small business owner, it is your responsibility to determine your payroll expense amount and pay these taxes appropriately. This can be a complicated process and often leads business owners to make costly, business threatening errors.

Small businesses that do not pay their payroll taxes are aggressively sought after by the IRS. Failure to pay, or over collection of tax comes with hefty fines and, in some cases, jail time. In many instances, restitution has been ordered, in the millions, for business owners who have been found guilty of fraudulent payroll tax accounting.

Ensuring that you handle your small business' payroll taxes correctly is important for both your business and your personal future. Seasoned financial professionals are well-versed on payroll tax law and can keep your business protected from payroll tax miscalculations.

Chapter 7:
The lack of a succession plan

As your small business grows, you'll need to move beyond the basics of financial planning. Investors and consumers want to know not only where you've been, but where you're going. You've invested more than just your hard-earned money, you've invested your time, talent and equity into starting and growing your business. If you need to step away, even temporarily, your business will need the resources and guidance to continue without your leadership. Squabbles between family members or employees can quickly escalate to business altering disputes.

Studies show that 88% of current family business owners believe the same family (or families) will control their business in five years. In reality, 30% of family and businesses survive into the second generation, 12% are still viable into the third generation, and only about 3% of all family businesses operate into the fourth generation or beyond[3]. This is why it's so important to develop a succession plan.

Why do I need a succession plan?

Your mind might be focused on building and growing your business, and understandably so, but what happens if you are injured? Do you have dreams of passing down your business to a family member or partner? Eventually, it will be time to retire or take a step back. Sometimes, unforeseen circumstances require business owners to step down or take a break, sooner than anticipated. Taking the time to determine who your successor will be and providing sound direction for business management can keep your business thriving if the unexpected happens.

Lack of time, being unfamiliar with the process and even fear can keep a business owner from developing a timely succession plan. Unfortunately, family disagreements, employee issues and weak leadership can quickly cause a business to tank. Leaving your business without a plan means leaving a lot up to chance. Asking your family and friends to make tough business choices can make a difficult situation even more stressful. It's not uncommon for family members to end up in lengthy legal battles over control of assets and business ownership.

3 Source: https://www.sba.gov/blogs/8-small-business-tax-preparation-mistakes-avoid

How do I develop a succession plan?

The options for business succession are vast. Once you exit, you might want your business to be sold, or you might already be training a future manager. A basic succession plan can be developed using online tools and templates. Succession plans should provide details for how business assets should be transferred, and who they should be transferred to. Determining the net worth of your business is a crucial first step in the planning process. This is a difficult figure to determine, but a financial professional can offer guidance.

Once you've chosen a successor (or successors) you should train him/her not only to run the day to day operations of your business, but how to make decisions that will benefit its future growth.

If you have not developed a plan like this before, or do not have legal expertise, hiring an attorney to assist with this process will ensure that it is executed appropriately. It is also a good idea to have a solid "Plan B" in place, in case your first plan does not work out. An attorney will guide you through each portion of the plan and develop guidelines for implementation.

Developing a succession plan is time consuming and may cause some short-term stress. This stress is minor compared to the unrest that can be caused due to lack of a solid succession plan.

Closing

The key to starting and maintaining a successful small business is to develop flexible, workable plans. Getting off on the right foot financially can set the tone for the entire future of your business. Taking proactive steps to ensure a solid financial future for you and your business, so that you can focus on the core service it provides, will save you countless hours of grief. This is why it's important that you consult with professionals when needed. By outsourcing your accounting, bookkeeping, and payroll management, you'll have more time to focus on growing your business. You'll also have peace of mind knowing that complex tax laws and regulations are being complied with properly.

Don't be afraid to ask for help. Financial hiccups are common, but they don't have to be an eventuality. Teaming up with a financial professional or accounting firm will help you to develop a strategy and avoid the financial pitfalls that many small business owners face.

How Lauzen Accounting Can Help

Lauzen Accounting is uniquely positioned to meet the needs of small businesses. Accounting for small business is all that they do and their experience gives them unique insight into the issues that small businesses face every day. For three generations, the Lauzen family has delivered professional accounting and tax solutions to help small businesses achieve their financial goals. They understand the challenges you face relating to cash flow, payroll, profit, and taxation and pride themselves in the many long-term relationships developed with clients.

Lauzen Accounting has expertise with a variety of industries, including manufactures, professional practices, medical, service companies, construction companies, restaurants, and other retail businesses.