Journal of Economic Analysis

Homepage: https://www.anserpress.org/journal/jea

Five Common Finance and Accounting Problems of Start-Up Companies

Derrald Stice [a, *], Earl K. Stice [b], James D. Stice [b]

[a] *HKU Business School, University of Hong Kong, Hong Kong, China*
[b] *Marriott School of Business, Brigham Young University, Provo, USA*

ABSTRACT

You have a product or service for which the world has been waiting. You've scraped together enough cash to get your idea off the ground. You are confident that your business will succeed. And yet, it is often the case that a short time later you are out of business. Numbers from the U.S. Bureau of Labor Statistics indicate that about half of new businesses fail within the first five years. And with those business failures go the life savings and the dreams of the person who started the business. This article describes five finance and accounting pitfalls that should be avoided in order to increase the likelihood that a small business will succeed. Of course, the most common reason for a small business to fail is that customers don't want the product or service. But small businesses are also often killed because of predictable and preventable finance and accounting mistakes: insufficient capital, poor cash management, poor record keeping and controls, improper product pricing, and uncontrolled growth.

KEYWORDS

Start-ups; cash flows; sales growth; product pricing; internal controls

---

* Corresponding author: Derrald Stice
E-mail address: dstice@hku.hk

ISSN 2811-0943
doi: 10.58567/jea02020005

Received 2 March 2023, Accepted 7 April 2023, Available online 19 April 2023, Version of Record 15 June 2023

1. Introduction

Although it is important to cautiously remember that the majority of small businesses fail[1], it is also important to remember that all successful businesses start small. Apple was started in 1976 by two friends, Steve Jobs and Steve Wozniak, working in the garage of Steve Jobs' parent's home in Los Altos, California. Microsoft was also started by two friends, Bill Gates and Paul Allen, who launched their business in 1975 in Albuquerque. Exxon Mobil was created in Cleveland clear back in 1862 through the entrepreneurial energy of one person, John D. Rockefeller. Walmart was also started through the energy of one person, Sam Walton.

In total, Apple, Microsoft, Exxon Mobil, and Walmart were launched through the creative energy of just six people. They were small businesses indeed. But now, these four companies that started as small businesses have a combined market capitalization of almost $2.5 trillion. The sad fact is that other entrepreneurs, unknown to us but with business ideas at least as good as those of John D. Rockefeller and Sam Walton, never had a complete opportunity to expand their businesses because they were stopped, in the early stages, by preventable finance and accounting problems.

One other thing to remember is that a business doesn't have to become large and famous to be a success. Solid small and medium size businesses are the foundation of communities. A good small business can provide jobs for family, friends, and neighbors. A parent or grandparent can feel success in passing on a financially stable small business to the next generation. With that said, no matter how you define business “success,” for each success story there are dozens of small businesses that die before they ever really get going.

In this article we describe five common finance and accounting problems that cause new businesses to struggle. Of course, this is not an exhaustive list, but these five problems seem to consistently arise in discussions of small business difficulties. Those five problems are: (1) insufficient capital, (2) poor cash management, (3) poor record keeping and controls, (4) improper product pricing, and (5) uncontrolled growth. We summarize these five problems in Figure 1. These problems are often interrelated. Uncontrolled growth can contribute to poor cash management. Poor cash management can be caused by poor record keeping. And so on. Although these problems are sometimes interrelated, we will address each one separately.

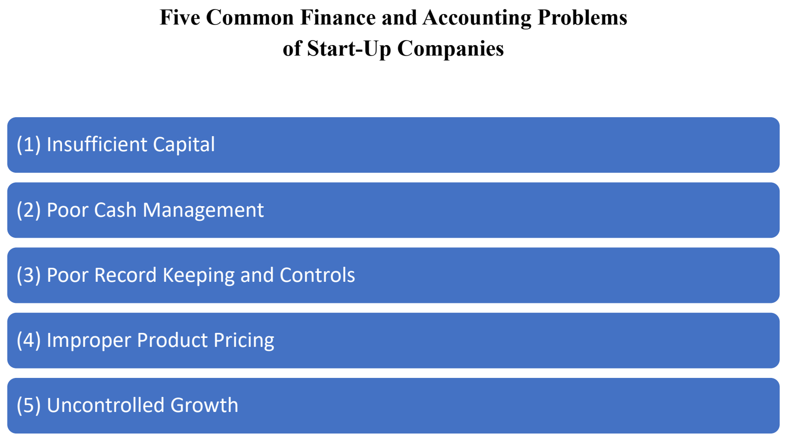

Figure 1. Five Common Finance and Accounting Problems of Start-Up Companies.

2. Background and Analysis

[1] United States Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics, March 2018. http://www.bls.gov/bdm/us_age_naics_00_table7.txt

2.1. Insufficient Capital

A friend of ours has recently entered the long-distance trucking business. He owns one truck, and he contracts with a driver to drive the truck for him. He finds his customers in companies that want to ship goods long distances but that don't have a big enough need to hire one of the large trucking companies.

Our friend originally thought that he could get into his trucking business with $35,000. But then he learned that used trucks that he could buy for $35,000 wouldn't be compliant with California emissions standards, so that meant buying a newer truck for $52,000. He also needed to buy a trailer, another $10,000, as well as tarps, straps, and chains for another $2,500. Finally, he also had to inject $10,000 in upfront cash to make the initial payment for insurance as well as for fuel, driver compensation, and repairs while waiting about two months for those initial customers to pay in cash. In total, our friend needed $74,500 to get his trucking business started. Fortunately for him, he had access to that much capital. But if his original supply of capital had been limited to, say, $50,000, the entire business venture would have died right there because of a lack of financing.

Would-be small business owners often don't think through all the costs of getting their business started. As a result, many small businesses are forced to close before they are able to find out if their business model has a chance to demonstrate that it's sound. By their very nature, entrepreneurs are optimistic … often OVERoptimistic (see e.g., Hmieleski and Baron, 2009). As a result, they usually overestimate their cash inflows and underestimate their cash outflows. They ignore the fact that when starting a business, it will take time for cash inflows to start flowing. But the cash outflows start flowing immediately.

How much cash is enough start-up cash? The answer to that question can only come through a careful budgeting of cash inflows and cash outflows. This is where the help of an experienced management accountant can be very valuable. As part of the initial business planning process, it is critical that the entrepreneur sit down with an advisor and carefully and realistically map out the expected cash inflows and outflows for at least the first six months of the new business. This start-up cash needs analysis will allow the owner to determine any forecasted cash shortage and will allow for enough time to arrange for needed financing, either from partners or from creditors.

2.2. Poor Cash Management

Many good businesses have died a premature death because they didn’t properly manage their cash flow (e.g., Stice, Stice, and Stice, 2017). A company can’t live very long when it doesn’t properly manage its cash flow to be able to repay it loans, pay its employees, pay its suppliers, and pay its taxes.

We have another friend who is a small business owner. We will disguise the actual nature of his business to preserve his privacy. He operates, let's say, a beach-side shop in a vacation beach area. He sells food, souvenirs, and some groceries. He also rents jet skis and scooters. His business is very seasonal, with high business in the late spring and summer and almost no business in the winter. To manage his variable cash flow throughout the year, he maintains a rolling 30-day cash flow projection. He forecasts how much cash he will collect from customers and how much cash he will have to pay the suppliers for each day for the next 30 days.

A few years ago, our friend experienced a business crisis that threatened his survival. It was rumored that one of the big cruise lines would begin using his harbor as a stopping point. Of course, this would dramatically increase customer traffic. Immediately, a large number of new competitors materialized. Our friend reports that new business owners came in, built or rented large store locations, filled them up with inventory, and purchased large collections of scooters and jet skis. A lot of money was invested in the area, and, for a time, our friend experienced threatening competition.

So, what happened? Well, the rumors turned out to be completely false. No cruise lines came to the harbor. Without sizable cash inflow from cruise line passengers, our friend’s new competitors couldn't maintain their cash payments for rent, inventory, wages and so forth. Our friend? He did great. Throughout the excitement he just calmly proceeded with his normal business practice of constantly balancing his expected cash collections and expected cash payments for the next 30 days. Because he carefully monitored his cash flow, he was able to safely ride out the bubble and the subsequent crash. After the crash, he actually made quite a bit of money… cheaply buying up the scooters and store inventory from his bankrupt competitors, the competitors who had not carefully planned and balanced their cash flows.

Cash management does not happen by chance. A key tool in managing cash is to have an understanding of the cash operating cycle. For a company that sells a product, the company's operating cycle is the amount of time that elapses from when the company buys its inventory until when the company collects the cash from selling that inventory. The length of the operating cycle is the sum of the length of two very different processes:

- How long from when a company buys its inventory until it sells or uses that inventory?
- How long from when a company makes a sale until the company collects the cash from that sale?

The first item is often called the "number of days' sales in inventory." The second is called the "average collection period." The length of these two time periods together constitute a company's operating cycle.

For example, Nike, maker of athletic shoes and other sportswear, has a number of days' sales in inventory of about 90 days and an average collection period of about 40 days. These two numbers combine to tell us that Nike purchases material for making inventory and receives the cash from selling that inventory in about 130 days.

When Nike purchases its raw materials on credit from its suppliers, Nike pays in about 45 days. But Nike doesn't collect the cash from selling the finished shoes and sportswear until a total of 130 days have elapsed. So, for 85 days (the difference between 130 days and 45 days), Nike has to use cash from other sources to keep its operation going. This 85-day financing gap is shown in the diagram below.

```
        Number of Days' Sales in Inventory      Average Collection Period
                     90 days                             40 days
|----------------------------------------|------------------------------|
|-----------------------------130 days----------------------------------|

|----------------|--------- External financing needed for 85 days ---------|
     45 days
 Number of Days'
   Purchases in
 Accounts Payable
```

If Nike wishes to manage its operating cash flow, the company has three "dials" it can turn.

- Number of days' sales in inventory. Streamlining the production process to get materials through the process as quickly as possible.
- Average collection period. Gently persuading its customers (retail stores) to pay a little faster.
- Number of days' purchases in accounts payable. Carefully stretching out the waiting time until paying suppliers.

This is all a balancing act. A rapid production process helps short-term cash flow but may cause quality control problems. More rapid cash collection pressure can alienate customers. And suppliers have their own cash flow concerns so will not wait patiently for payment forever. Start-up business owners can better navigate this cash flow balancing act with the help of an experienced business advisor.

In a steady state, Nike, and other companies, can use cash collected from prior sales to pay for the materials purchased to make goods for future sales. But in a growing business, where cash payments to make goods for future sales are greater than cash collected from past sales, this operating cycle mismatch can create large operating cash flow shortfalls.

Of course, cash management is not an absolute business requirement. Small businesses are not legally required to consider the implications of their cash operating cycle and to prepare cash budgets. So, here is our recommendation to all start-up business owners: If you like chaos, excitement, uncertainty, and unexpected problems that must be solved within five minutes, then do NOT practice cash management. Cash planning leads to a much more sedate, orderly, and boring existence … and leaves more time and mental energy for the small business owner to spend on actually running the business, serving customers, and creating new products and services.

2.3. Poor Record Keeping and Controls

As most business advisors have observed, many small businesses have almost no organized financial records at all. Here is a real example of the consequences of the poor recordkeeping practices of a small business. One of us was approached by a friend who was thinking of buying a small furniture-making business. This furniture-making business had been started and operated as a family business, but now the owners wanted to sell and move on to something else. Our friend asked for help in determining how much to pay to buy this business.

We asked to see the accounting records of the furniture-making business and were dismayed, but not surprised, to learn that the “records” were a mess. In fact, after a few hours of piecing through the data dump, it was clear that it was going to be impossible to separate business spending from personal household spending. In the end, we strongly suggested to our friend that he not buy this business, for two reasons. First, it was impossible to value the business because no reliable numbers could be extracted from the pile of data with which to estimate revenues, costs, profits, or anything else. Second, the fact that this business was being operated without even the most rudimentary bookkeeping system was a signal of a more general carelessness perhaps impacting production quality, customer relations, and everything related to the business. Note: Our friend decided not to buy the business.

Some small businesses do well in spite of their bookkeeping inefficiencies because their fundamental business is doing so well that the inefficiency stemming from bad record keeping only reduces profits instead of eliminating them altogether. But of course, most small businesses do not survive, and poor bookkeeping is a contributor to the demise of many of them. Poor bookkeeping leads to a host of problems: trouble collecting accounts, difficulties with suppliers over late payments, problems getting bank loans because of the inability to prove profitability, inability to assemble reliable costs and revenue data in order to make pricing decisions, and just general inefficient use of time. In addition, poor bookkeeping is often a symptom of a more fundamental laxness that adversely affects all aspects of the business.

The label that we accountants give to a company’s collection of systems and procedures for keeping complete and accurate records is “internal control.” Internal controls also ensure that valuable resources are safeguarded and that only authorized transactions occur. A classic example of internal control is the separation of duties. Simply stated, the idea of separation of duties is that hands that touch assets, such as cash, should not also be allowed to touch the accounting records associated with those assets. For example, the person who makes the physical cash deposits in the bank should not be the same person who maintains the record of how much cash is in each deposit. If a person has access to the asset and to the accounting records, a theft or error can be easily concealed just by adjusting the records.

This description of the separation of duties should set off alarms when you remember that we are talking here about small businesses. In a small business, it often is not feasible to construct nice organization charts with clearly defined spheres of responsibility. Instead, in a small business, everyone has to be prepared to do almost everything. But the ideal of organized systems and proper separation of duties should be kept in mind.

One other thing to keep in mind is the famous “Fraud Triangle” (Albrecht, 2014). For an employee to attempt a fraud, three conditions are necessary: personal financial pressure, ability to rationalize, and perceived opportunity. Good internal controls reduce the perceived fraud opportunities and thus protect both the financial resources of the small business owner as well as the owner’s relationships with the close-knit set of friends/employees typical in a small business.

A good system of record-keeping and controls is what the mathematicians call a necessary but not sufficient condition. A good information system and good internal controls will not ensure the success of a business, but bad systems and controls will certainly contribute to a lack of success.

2.4. Improper Product Pricing

One of the problems that small business owners have is that they improperly price their products and services. Sometimes they set their prices too high, driving away business, but more often they set their prices too low and end up not covering all of their costs.

One of us has a personal experience with this, a story with a good ending. One of us operates a small business providing executive training courses. A few years ago, he was invited to provide a one-day training course to a group in Kuala Lumpur. The group asked him to quote them a price for this one-day course.

The pricing issue was this: What can be reasonably charged for a one-day course? Because the inviting organization just wanted the one day, his first thought was, "Well, how much would I accept for one day of work?" Would he do it for $1,000? Most people would be happy to make $1,000 a day. That is what he thought until he considered the question some more and realized that it would take him about five working days to design the course. So, it was one day of work for the delivery of the course but five days of course design. Was he willing to work for six days for just $1,000? Now it seemed that a more reasonable fee would be something like $5,000.

Then he began to think about the travel time. Kuala Lumpur, locally known as KL, is the capital of Malaysia. At the time, he was living near Salt Lake City, Utah in the United States. He checked the flight schedules and learned that he would have to fly from Salt Lake City to San Francisco (2 hours), from San Francisco to Hong Kong (another 13 hours), and then from Hong Kong to Singapore (an additional 4 hours). And that wasn't the end. He would have to then sleep overnight in the Singapore Airport to catch the 6:00 a.m. flight the next morning to Kuala Lumpur. All told, with travel time to and from airports and airports waiting times, it would take him almost two full days to get from Salt Lake City to Kuala Lumpur, and then about the same amount of time to get back. That is a total of four days of travel.

If you add it all up, this one-day course would consume about 10 days: one day of delivery, five days of preparation, and four days of travel. Add to this a few days of serious jet lag upon the return from this 20,000-mile round trip, and the total time consumed for this "one-day course" would be about two weeks.

What price did he finally quote? Well after thinking about all the costs in terms of time and effort, he proposed a price of $15,000. For one day, $15,000 seems outrageous, but it begins to appear a little more reasonable after you think through all of the costs involved. Did the company accept this price? Well, that's the good ending… he asked for $15,000, and they said "yes." He designed the course, flew across the Pacific, slept overnight in the Singapore Airport, delivered the course in Kuala Lumpur, turned right around and flew back, and then enjoyed a few days of glorious jet lag at home in Utah.

The point is that he couldn't quote a proper price until he had carefully considered all of his costs. A common mistake of small business owners is that they don't consider all of their costs when setting their prices.

What can be so hard about pricing a product? In many cases you are a price taker and will have to accept whatever price is determined by the market. In that case you have to manage your costs so that you can earn a profit given the market-determined price. To repeat, in many instances you don't price your product to cover your costs but instead you determine whether your cost structure will allow you to earn a profit given the market price.

In other circumstances, when products are differentiated instead of being identical, product cost is an important determinate in setting the selling price. The biggest mistake new business owners make in product pricing in these circumstances is to not consider all of their costs when entering a market. Now, it is true that when you are initially trying to penetrate a market you may be willing to lose a little money to gain market share, but that strategy is not sustainable over time. Over the long term you must cover all of your costs (Kaplan, 1992). This is a situation in which a business advisor can help a start-up business owner identify all of her costs: direct costs, overhead costs, and even opportunity costs.

2.5. Uncontrolled Growth

We all know about the NFL, the National Football League, but these days not many people remember the USFL. The USFL was the United States Football League, a rival professional football league that operated for three seasons from 1983 through 1985. That first season, 1983, saw the USFL owners as a group lose millions of dollars. These losses were caused by fan interest being less than expected and player salaries being more than expected.

In response to these losses in 1983, the USFL owners tried to fix their profitability problems with an approach that is often used by small businesses owners -- they tried to grow their way into profitability. The simple rationale was as follows: If we grow faster, we will become more profitable. This is a typical mistake. A better approach is to first fix the profitability of your existing operations, and then think about growing. But the USFL owners made the common mistake of thinking that they could outgrow their profitability problems. Let's see what happened.

In the second season, 1984, the USFL grew in two ways. First, they expanded the number of teams. In the inaugural season there were 14 teams. In the second season the League expanded to 18 teams. Second, the teams grew their player payrolls. The initial plan was to hold to a strict salary cap of $1.8 million per team. But some of the owners couldn't resist signing expensive big-name players to try to raise the profile of the League. Some of the well-known players who got their start in the USFL were running back Herschel Walker, who was paid $1.4 million per year by the New Jersey Generals, and quarterback Steve Young, from our own alma mater of Brigham Young University, who signed a 40-year $1 million per year contract. Steve Young's $40 million contract was, at the time, by far the largest contract in professional football history, even surpassing all of the big stars in the established NFL.

As expected, this rapid growth strategy in number of teams and in player salaries failed to turn the money-losing USFL into a money maker. After the 1985 season, the League ceased operations. In its brief three-year history, the team owners lost a total of at least $180 million. The lesson? If you've got profitability problems or cash flow problems, faster growth is almost always not the solution.

As illustrated by the case of the USFL, growth is seductive, but unmanaged growth has killed a lot of businesses. Growth must be carefully done or it can be fatal (Bianchi and Winch, 2009). A key reason for this is something that we discussed earlier: cash flow and the operating cycle. The faster a business grows, the more inventory it must purchase and pay for before starting to cash collect from its own customers.

There are also non-financial reasons to be wary of rapid growth. A high-growth company has difficulty maintaining discipline in its operating practices because things are constantly changing. In addition, high-growth companies have difficulty with consistency hiring reliable employees; there just isn't enough time to properly screen the large number of new employees needed in the growing operation.

Growth is often not the cure; it is the disease. And the faster you grow, the faster you die. For small business owners focused only on growth, there is some good news: the cash flow death that will come will be quick, leaving the bankrupt owner many years to look back and ponder what went wrong. Sometimes the best counsel a wise business advisor can give to a start-up business owner is to "slow down."

3. Conclusion

To avoid these common finance and accounting problems, it often makes sense for a start-up business owner to spend a little money to meet with an experienced business advisor. The entrepreneur can describe to this outside advisor the business, the plans, and the frustrations. The advisor can then help the start-up owner sort through the weaknesses of the business to identify the things to work on first. Related to the five common accounting and finance we discuss an outside consultant can help an entrepreneur rank and prioritize which problems to tackle first. Business advisors and consultants with a proven track record and reputation for quality and honesty will often prove to yield the best return on investment.

Small businesses are the source of creativity in an economy. A small business is a precious thing, the embodiment of a person's ideas, energies, and ambitions. Society needs those who have the entrepreneurial spirit and have started or are thinking of starting their own small business. A little knowledge about accounting and finance can help protect these important small business owners.

Funding Statement

This research received no external funding.

Acknowledgments

This article is intended to be useful for instructors and students of accounting, finance, and business. We thank many colleagues and students for helpful comments and suggestions.

Declaration of Competing Interest

The author claims that the manuscript is completely original. The author also declares no conflict of interest.

References

Albrecht, S. (2014). Iconic Fraud Triangle Endures. *Fraud Magazine.* July/August Volume.

Bianchi, C., and Winch, G. (2009). Supporting value creation in SMEs through capacity building and innovation initiatives: the danger of provoking unsustainable rapid growth. *International Journal of Entrepreneurial Venturing* 1(2): 164-1. https://doi.org/10.1504/IJEV.2009.029102.

Hmieleski, K., and Baron, R. (2009). Entrepreneurs' optimism and new venture performance: A social cognitive perspective. *Academy of Management Journal* 52: 473-488. https://doi.org/10.5465/amj.2009.41330755.

Kaplan, R. (1992). The evolution of management accounting. Published by Springer U.S. DOI: 10.1007/978-1-4899-7138-8_27.

Stice, D., Stice, E., and Stice, J. (2017). Cash Flow Problems Can Kill Profitable Companies. *International Journal of Business Administration* 8(6): 46-54. https://doi.org/10.5430/ijba.v8n6p46.