

BUSINESS FAILURES: THEIR CAUSES  
AND MITIGATION

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BUSINESS FAILURES: THEIR CAUSES  
AND MITIGATION

by  
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THESIS

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## I. INTRODUCTION

### Scope and Purpose of Study:

Many studies have been made in the past about business failures and their causes, but few people try to understand the real importance of such studies. Business failure is an economic disease so widespread in its effects, and so disastrous in its results that serious effort should be directed toward the problem of creating preventive and remedial measures. Enormous losses are suffered by those who finance the business, and by the consumer who shares in the tremendous economic waste arising from business failure. Many failures can be prevented, if the owners of active concerns will utilize the knowledge gained from a study of the causes of failure among other merchants. A further reduction in business failures will result, if those expecting to enter business are warned of the dangers and heed the mistakes made by others.

The purposes of this study are both factual and remedial. It is proposed first to secure and present statistics showing the extent of business population, and both the extent of failures and the financial loss resulting from such failures. The data will as far as possible be limited to the past ten years, but more particularly to the period following World War II. Secondly, the causes of failures affecting business

enterprises will be examined under two heads, viz, permanent or fundamental causes, and temporary causes. It is felt that this examination will be necessary and important, if effects are to be studied, and remedial measures are to be suggested. In the third place, attention will be directed toward the effects of failures both upon the economy as a whole and upon the people involved in business. Finally, it is hoped that, as a result of this study, suggestions or proposals can be made, which will stimulate efforts to reduce the numbers of business failures, and to mitigate the financial loss resulting from those failures.

#### Method of Study:

Those who deal with human relations and social conditions find that the present is always rooted in the past, and consequently believe that the future is rooted in the present.<sup>1</sup> This established fact suggests that, in order to understand the problem at hand, one must probe into the past. The library was the laboratory for this work. Some of the factual data were gathered from the United States Department of Commerce, and Dun and Bradstreet, Inc. The names of authors and bulletins that were relevant to this subject and aided my task are given under

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1. Landis, P. H. "The Growth and Decline of South Dakota Trade Centers 1901-1933." p. 4.



the section of Bibliography. Discussions with the intellectuals also helped me to clear some of the doubts that occurred in my mind.

### Definitions:

While most of the terms used here, are subject to the general interpretation, the term 'business failure' is given little explanation. There is no generally accepted meaning to this term.

The reports of Dun and Bradstreet, Inc. indicate that not every concern that goes out of business is a failure. Most of the withdrawals from business are due to changes in ownership and voluntary liquidations in which there is no indication of loss to creditors. A business failure involves a court proceeding or voluntary action which is likely to end in loss to creditors. Withdrawals may actually be profitable liquidations, although the majority involve some loss of personal capital. And the Dun's Reports often include as failures only those businesses liquidated or sold because of insolvency. They are called 'commercial failures'.

Many are opposed to that narrow definition. Ulmer asserts that "business failures, in the broad economic sense, refer to closures attributable to the necessity for avoiding losses. On the other hand, 'commercial failures', as narrowly defined, usually refer to closures

which result in a known loss to creditors."<sup>1</sup>

Frequently the owner of a small establishment simply closes up and disappears without notifying his creditors, who divide up the remaining assets, if any, without the assistance of an outside agency. In such cases the discontinued business is not recorded in the failure lists. Furthermore, concerns that discontinue business with a loss to owners but not to creditors are not included in the statistics of business failures. So, Converse<sup>2</sup> and others<sup>3</sup> indicate their desire to enlarge the meaning of business failures.

A business failure will mean:

- a. liquidation or sale of a business while insolvent, with a loss to creditors;
- b. sale of the business because, it is operated at a loss, and the owner wants to salvage a part of his original capital; or
- c. lack of success in earning, what the owner considers a satisfactory return for his services and capital.

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1. Ulmer, M. J. "Survey of Current Business," Jan., 1947. p. 5.
2. Converse, P. D. & Huegy, H. W. "Elements of Marketing". p. 537.
3. Starr, G. W. & Steiner, G. A. "Indiana Business Studies" No. 19, p. 6.

Anyone quitting business for any of the above three reasons will be a 'business failure'. Under this broader term, every 'commercial failure' as defined by Dun and Bradstreet, Inc., is a 'business failure'; but every 'business failure' is not necessarily a 'commercial failure'.

In addition to those who fail in the above sense of the term, many sell or close their business because of old age, sickness, death, or a desire to retire. Not all of those quitting business incur a loss. Business mortality or discontinued business includes closures of all kinds without reference to the reason for going out of business. So, the mortality rate is the ratio of the number of concerns going out of business for all reasons whatever, to the total number of those doing business.



## II. EXTENT OF BUSINESS POPULATION AND BUSINESS FAILURES

Before going into the causes of business failures, it is proposed to present statistics, showing the extent of business population and that of failures and liabilities.

### Number of firms in operation:

The available statistics from the United States Department of Commerce give the change in American business population during the period 1940 through 1947. (Table 1.) Beginning with the attack on Pearl Harbor, the number of firms in operation in the United States declined sharply until the end of 1943 (2.8 millions). By the end of 1946, the business population (3.6 millions) had regained its war time loss and exceeded its prewar peak of nearly 3.4 millions in 1941.

Underlying this unprecedented advance, which is illustrated in Chart 1, were the familiar characteristics of the reconversion period -- the release of men from the armed forces, the gradual easing of material supplies for civilian use, rising sales in all lines, and the apparent abundance of profit opportunities presented by the long-deferred demands for the numerous commodities produced in only limited quantities or not at all during the war

Table 1

Number of business firms in operation, and new  
and discontinued businesses. 1940 - 47.

## All Industries.\*

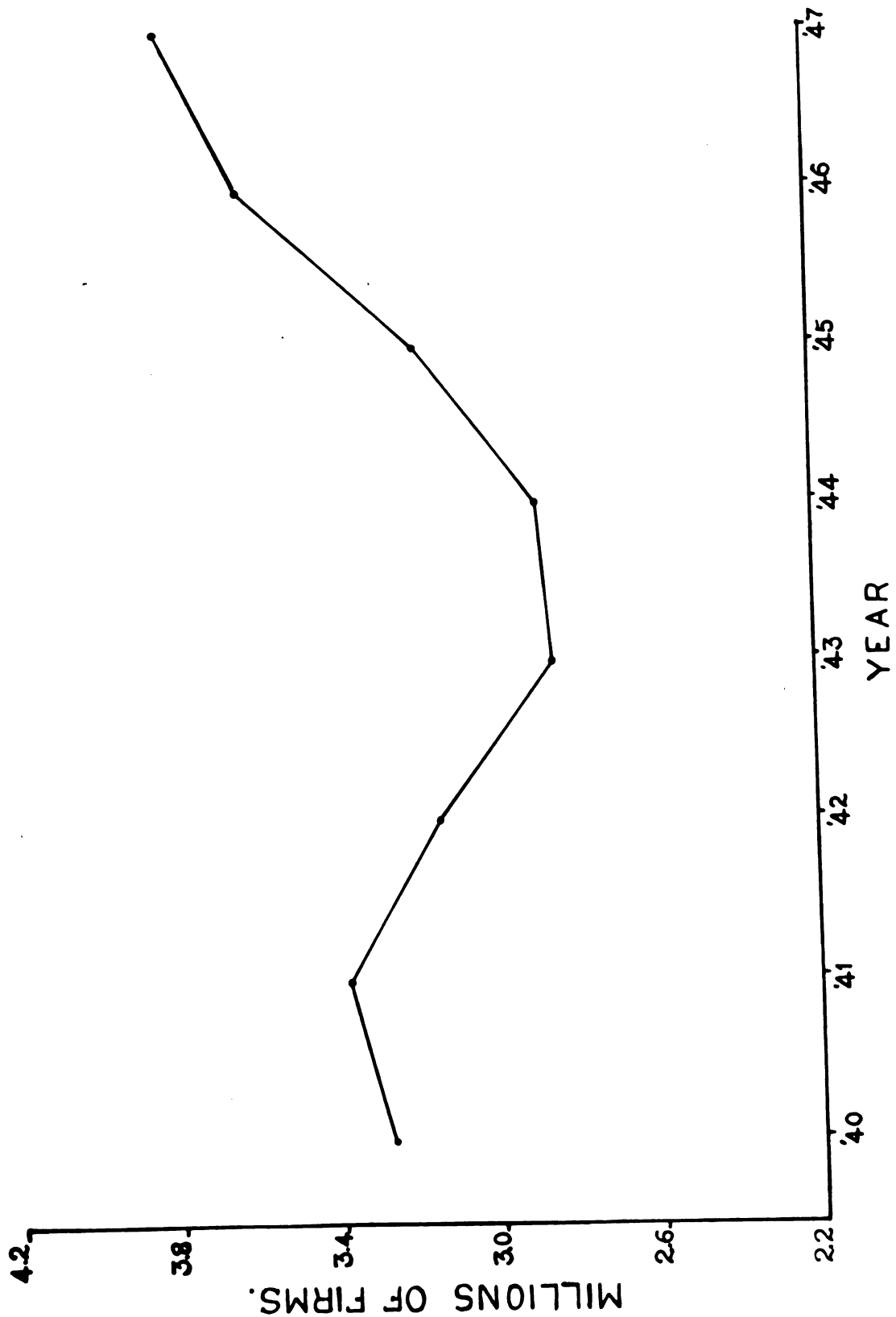
Year	No. of Operating Bus. Firms (in thousands)	New Business (in thousands)	Discont'd Business (in thousands)
1940	3298.2	357.3	360.5
1941	3398.0	447.6	410.8
1942	3155.7	334.7	604.4
1943	2860.6	143.4	379.1
1944	2923.5	272.8	143.5
1945	3224.1	411.8	152.5
1946	3657.8	615.3	181.7
1947	3848.3	409.3	218.7

Source: U. S. Department of Commerce

\* "Includes all firms outside of agriculture, forestry, fishing, and the professional services. The present Social Security Administration industrial classification, incorporating revisions introduced since the Office of Business Economics series were started, is used for all industry divisions." (Churchill, B. C. Survey of Current Business, June, 1949. p. 19.)

CHART 1:

TOTAL NUMBER OF FIRMS IN OPERATION,  
1940-1947.





years.<sup>1</sup> Again the number of firms in operation in 1947, rose to more than 3,800,000; which was approximately in line with the high level of general business activity.

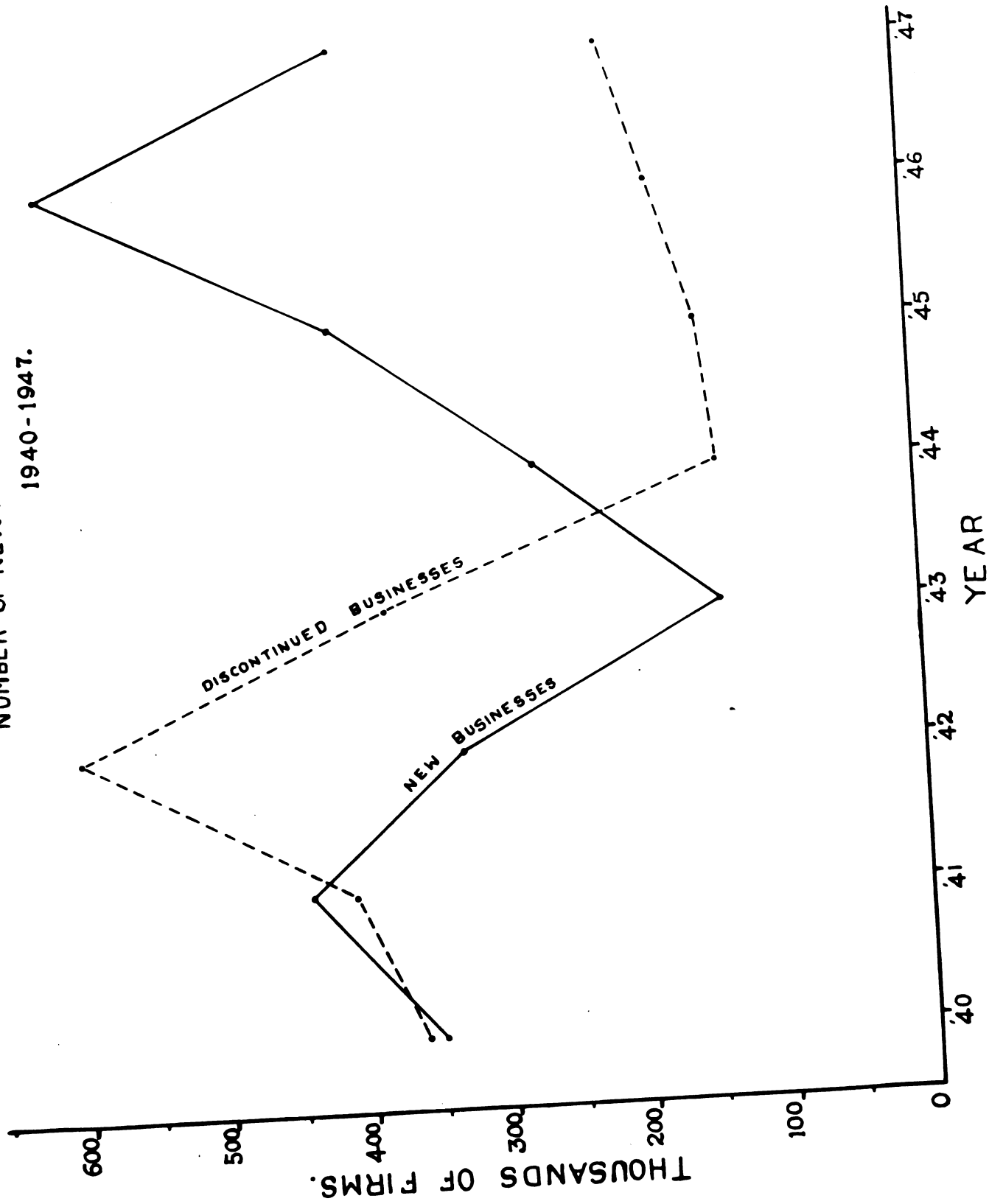
#### New and Discontinued Business:

The wide range of the fluctuations in both the level of discontinued businesses, and of new businesses since 1940, is illustrated in Chart 2. The sharp bulge in discontinuances during the war period, of course, was occasioned primarily by special war time factors like scarcity of materials and merchandise, shortage of labor, rise in labor cost, etc.<sup>2</sup> The spread between the high level of discontinuance and the low level of the number of new businesses from 1941 through 1943, indicates the magnitude of the decline in the business population during those years. Similarly, the magnitude of the subsequent rise is shown by the increasing gap between the two series from 1944 to 1946, when the number of new businesses resumed their position above discontinuances. This gap was narrowed down in 1947, showing that the entry of new firms was limited to 409,000, while the number of discontinuances was increased to 218,000. Such was the extent of the American population from 1940 to 1947.

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1. Ulmer, M. J. "The Postwar Business Population," Survey of Current Business. Jan., 1947. p. 1.
  2. Ulmer, M. J. & Nielsen, A. "Business Turnover and Causes of Failure", Survey of Current Business. April, 1947. p. 3.

CHART 2:

NUMBER OF NEW AND DISCONTINUED BUSINESSES.  
1940-1947.



Analysis of Dun and Bradstreet's data:

While the previous figures indicate clearly the extent of business population through 1947, later data from the source quoted, were not available for the period of this study. So, the reports of Dun and Bradstreet, Inc. are also analyzed to show the current extent of business population, failures and liabilities. The data from 1939 to the first-half of 1949, are given in Table 2.

They differ from the United States Department of Commerce in number of operating firms and discontinued business; because the Dun and Bradstreets have their own Reference Book for listing the concerns and rating according to their credit and capital status. Further, they list only 'commercial failures' as distinguished from 'business failures' in the earlier chapter. Also, they do not include all firms as found in the Social Security Administration industrial classification.<sup>1</sup>

Because of shortages and market conditions caused by World War II, the business population of the country in early 1944 (Chart 3) had dropped to its lowest level since 1920. But, once World War II was over, Americans began to go into business for themselves, in numbers never before approached in the history of American business. It

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1. Churchill, B. C. "Survey of Current Business". June, 1949. p. 19.

Table 2

## Failure Statistics, 1939-1949\*

Year	Total Listed Concerns	<u>Business Failures</u>		Failure Rate Per 10,000	Average Liability Per Failure
		Number	Liabilities		
1939	2,116,000	14,768	182,520,000	70	12,359
1940	2,156,000	13,619	166,684,000	63	12,239
1941	2,171,000	11,848	136,104,000	55	11,488
1942	2,152,000	9,405	100,763,000	45	10,713
1943	2,023,000	3,221	45,339,000	16	14,076
1944	1,855,000	1,222	31,660,000	7	25,908
1945	1,909,000	810	30,395,000	4	37,524
1946	2,142,000	1,130	70,349,000	5	62,256
1947	2,405,000	3,476	221,048,000	14	63,593
1948	2,550,000	5,252	310,566,000	20	59,133
1949*	2,679,000	4,581	232,635,000	34*	50,783*

Source: Dun and Bradstreet, Inc.

\* First 6 months average.

seems that, in 1946, the names of 647,000 new concerns were added to the Dun and Bradstreet Reference Book, and in the following year, 712,000 new concerns were established; and this was at the average rate of 2,250 for every business day.<sup>1</sup>

#### Increase by States:

This new business 'fever' was not centered in any one part of the country. There was business expansion from coast to coast, in small states, and in the larger ones, in the farm belt, and in the large industrial centers. New Mexico's business population increased by 88 per cent from January, 1944 to January, 1949. In the same period, Florida's jumped by 74 per cent, Alabama's 66 per cent, Texas' 52 per cent, and California's 49 per cent. The only decline in this five year period (1944-49), in which the business population of the country jumped by 34 per cent, occurred in the District of Columbia, which had 1,500 fewer concerns in 1949 than in 1944.

The per cent of change in business population for 1944 and 1949 by all states is shown in Appendix A.

The greatest numerical increase between 1944 and 1949 took place in New York, with a 72,000 addition to the business population. California had a 62,000 increase. Other

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1. Dun and Bradstreet, Inc., "A Progress Report on New Business Enterprises in the U.S." p. 2.

large numerical gains were scored by Texas with a 46,000 increase, Ohio with 30,000, Pennsylvania with 28,000, and Michigan with 25,000.

The reader will now turn from an examination of the history of the over-all business population of the country during the past ten years to the report on business failures.

#### Failures and Liabilities:\*

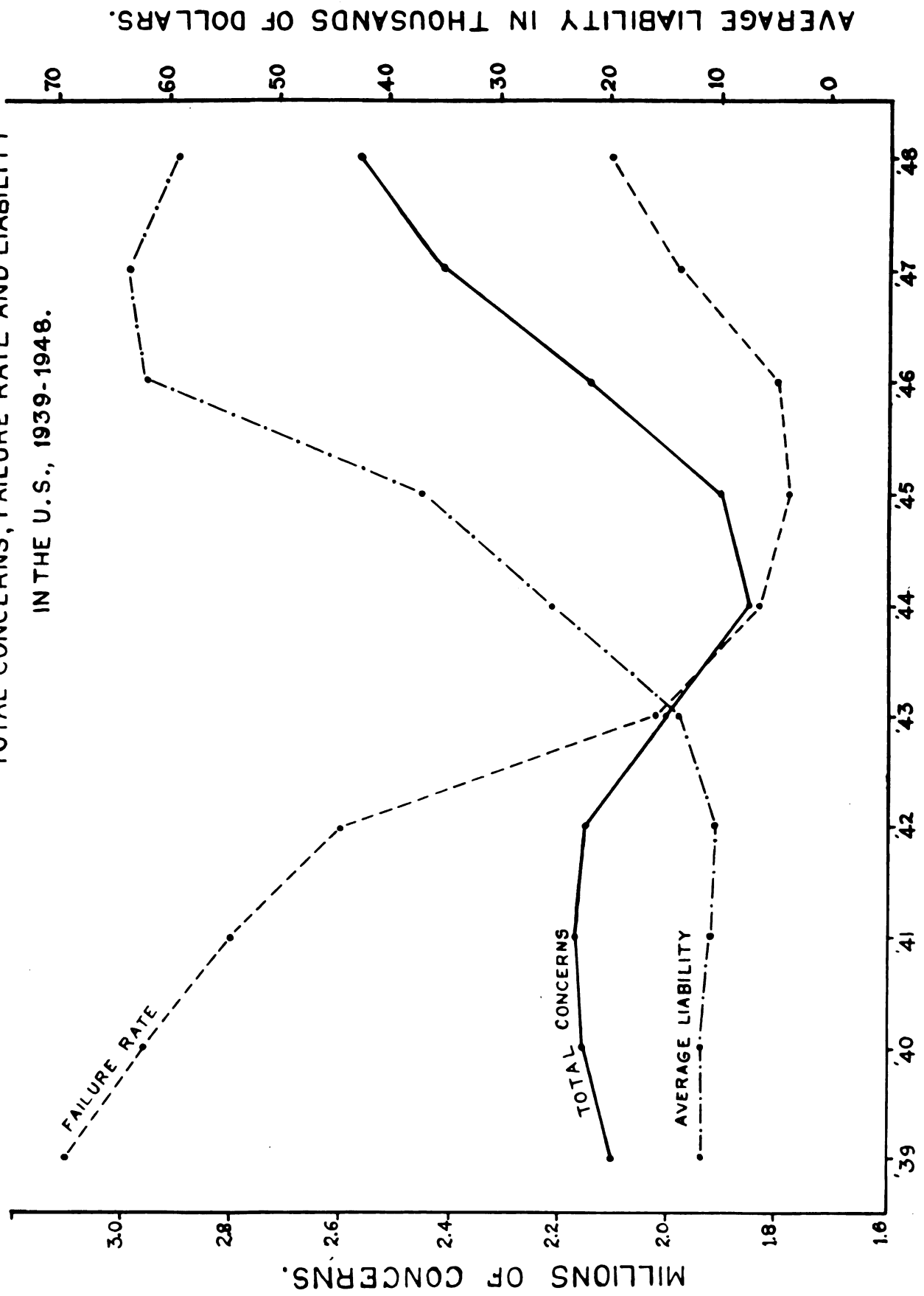
According to the Report of Dun and Bradstreet, since 1920, an average of 70 concerns out of every 10,000 in business have failed each year. The high point occurred in 1932, with 31,822 failures, or 154 for every 10,000 concerns in operation with an average liability of \$29,172 per failure. The year 1939 had a normal failure rate of 70 per 10,000, while the average liability was \$12,359 per failure. In 1942, the failure rate was declining (Chart 3) and the liability reached its lowest figures (average of \$10,713 per failure). Soon after World War II, largely because of the existence of a seller's market in most lines of business, failures declined sharply. The 810 failures reported in 1945 were less than any year since

#### \*Note on liabilities:

The liabilities incurred in business failures represent primarily current indebtedness, which include all accounts and notes payable, and all obligations, whether in secured form or not, known to be held by banks, officers, affiliated companies, supplying companies or the government.

CHART 3:

TOTAL CONCERNS, FAILURE RATE AND LIABILITY  
IN THE U.S., 1939-1948.



NUMBER OF FAILURES PER THOUSAND.  
AVERAGE LIABILITY IN THOUSANDS OF DOLLARS.

1865. But from 1946 to this day, the failure rate is again on the forward march. The rate has increased from 5 per 10,000 in 1946, to 34 per 10,000 in 1949 (which is the average for first six months of 1949.)

Although the number of failures that have occurred during the past few years has been small, the average liability per failure in 1948 was almost five times what it was in 1940. Current high costs and prices involved in setting up a business, and maintaining its operation, are greatly responsible for this marked increase in average liabilities.<sup>1</sup>

While the failures by divisions of industry and geographic regions for 1949, are given in Appendix B, an illustration of failures by divisions of industry are given below for the first half of 1949.

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1. Dun and Bradstreet, Inc. "A Progress Report on New Business Enterprises in the U.S." p.3.



## Failures by Divisions of Industry -- June, 1949

(Current liabilities in thousands of dollars)

	Number Jan.-June, 1949	Liabilities Jan.-June, 1949
<u>Mining &amp; Manufacturing</u>		
Mining, coal, oil, misc.	27	3,393
Food and kindred products	131	9,417
Textile mill prods. & apparel	184	9,864
Lumber and lumber prods.	190	11,847
Paper, printing & publish- ing	48	4,038
Chemicals & allied prods.	36	861
Leather & leather prods.	53	2,179
Stone, clay & glass prods.	31	1,650
Iron & steel & prods.	83	7,491
Machinery	142	15,926
Transportation equipment	41	4,119
Miscellaneous	194	9,129
Total Mining & Manufacturing	1,160	79,914
<u>Wholesale Trade</u>		
Food and farm products	155	7,402
Apparel	31	1,282
Dry goods	18	399
Lumber, bldg. mat'ls, hdwe.	55	2,560

	Number Jan.-June, 1949	Liabilities Jan.-June, 1949
<u>Wholesale Trade - Cont.</u>		
Chemicals & drugs	27	929
Motor vehicles & auto equip.	36	1,141
Miscellaneous	237	9,804
Total Wholesale Trade	559	23,517
<u>Retail Trade</u>		
Food and liquor	449	5,757
General merchandise	88	908
Apparel & accessories	295	5,224
Furniture, house furnishings	245	5,006
Lumber, bldg. mt'ls, hdwe.	133	2,503
Automotive group	207	3,824
Eating & drinking places	381	8,510
Drug stores	54	941
Miscellaneous	228	3,572
Total Retail Trade	2,080	36,245
<u>Construction</u>		
Gen'l bldg. contractors	157	7,281
Bldg. sub-contractors	225	3,913
Other contractors	16	1,621
Total Construction	398	12,815

	Number Jan.-June, 1949	Liabilities Jan.-June, 1949
<u>Commercial Service</u>		
Passenger & freight trans.	134	71,237
Misc. public services	9	4,697
Hotels	13	412
Cleaning, dyeing, repairing	47	728
Laundries	21	695
Undertakers	5	46
Other personal services	34	481
Business & repair services	121	1,848
Total Commercial Service	384	80,144
Total United States	4,581	232,635

Source: Dun and Bradstreet, Inc.

The largest number of failures are being reported in the highly industrialized Middle Atlantic States -- states of New York, New Jersey and Pennsylvania. But this is not surprising since that part of the country is the most heavily business populated region. The failure rate based on the number of failures and business population in the nine geographic regions of the U. S. (See Appendix C, for explanation of those 9 regions), was higher in the Middle Atlantic States in 1940. The popular merchantile agency\* also reports that, in 1948, the westward expansion of business reflected itself in the failure rate in that part of that country. The Pacific Coast, comprising the states of Washington, Oregon, and California, has the highest failure rate.

#### Initial Investment:

Because of increased operating costs, it takes much more capital to get a business started today than it did ten years ago. A Dun's report says that during 1945-47, according to a Department of Commerce Survey of 1,000 new concerns, the average initial investment of a new retailer going into business was \$9,500. The average new wholesaling business established in this same period represented an initial investment of \$22,000.

Naturally, the initial investment involved in setting

\*Dun and Bradstreet, Inc.

up a business varies with the line of business. Some lines demand larger and more expensive inventories than others. Fixtures and the size of the outlet are other factors. According to that study, the initial investment range required was from \$5,600 to start a filling station, to over \$25,000 for opening up a building materials business. This is the main reason for increased liabilities resulting from business failures of today.

The current increase in failures:

The current increase in failures reflects the well-established business axiom: "Most business enterprises die young. Less than half live to celebrate their fourth birthday. Fewer than a third have a life span of ten years or more. The tremendous increase in new enterprises means an almost inevitable rise in business failures in the near future."<sup>1</sup>

After studying the business mortality of Illinois retail stores from 1925 to 1930, Converse came to a similar conclusion<sup>2</sup>, namely, that the mortality among new dealers was much higher than among long established dealers. A great many of the incompetent, newly established dealers fail within a year. It appears that most of the poorly

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1. Newsweek. May 19, 1947. p. 74.

2. Converse, P. D. ("Business Mortality of Illinois Retail Stores from 1925 to 1930") Bulletin No. 41, p. 33.

prepared store owners quit by the end of the second year following that in which they start.

How long were most of the concerns that failed in 1948 in business? After an examination of the Table 3, it can be seen that most of them had not been in business too long. The bulk of them, 69 percent, or 3,021 concerns to be exact, began operating since 1945, while 89 percent of them, or 3,897 concerns entered the business scene between 1939 and 1948. Less than one-half of one percent of the concerns that failed in 1948 were established prior to 1900. To some extent this reflects a great degree of soundness among the concerns, which have been in business many years.

This study of 4,381 of the business failures, that occurred in 1948, includes retailers, wholesalers, and manufacturers.

It is increasingly evident, that the chance of business failure, during the first few years of operation, is usually greater than after the concern has been in business for more than five years; because, that is the real testing period of the ability, stamina, and management instinct of the owner. In this period of relative trial and error, the rate of mortality is greatest.

Table 3

A Study of 4,381 Business Failures in 1948,  
by Year of Establishment

Starting Year	Number	Percent	Starting Year	Number	Percent
1948	212	4.8	1936	36	0.8
1947	1,017	23.3	1935	40	0.9
1946	1,183	27.0	1934	31	0.7
1945	609	13.9	1933	31	0.7
1944	327	7.5	1932	27	0.6
1943	149	3.4	1931	21	0.5
1942	106	2.4	1930	17	0.4
1941	108	2.5	1925-1929	48	1.1
1940	106	2.4	1920-1924	43	1.0
1939	80	1.8	1900-1919	64	1.5
1938	62	1.4	Before 1900	18	0.4
1937	46	1.0	Total con- cerns	4,381	100.0

Source: Dun & Bradstreet, Inc.

### III. CAUSES OF BUSINESS FAILURES

We have noted that <sup>the</sup> ~~the~~ business population in the United States <sup>had</sup> ~~increased~~ by 34 percent in 1949, over 1944 population, and that this expansion occurred in every part of the country. During World War II, the failures were few. In 1945, only 810 failures were reported, and this was primarily due to the existence of a seller's market in most lines of business. In 1948, the number of failures was 5,252; the failures mounted to 4,581 for the first-half of 1949. The liabilities of the concerns which failed have increased greatly. The average liability per failure, in 1948, (\$59,133) was almost five times what it was in 1940, (\$12,239).

These facts are enough to show the extent of business failures, and to merit the serious consideration, and appropriate action of all persons interested, and influential in stabilizing business units, either individually or collectively. Now, the question arises why and how these failures occur. The answers will be discussed in the following pages.

— *IV*

American business consists mainly of firms engaged in manufacturing, wholesale trade, retail trade, construction and commercial services. Retail and small businesses form the major part of the number of operating firms. So, the failures are correspondingly numerous in this retail



trade group. Each industry has its own reasons for its failure in its area. Business is so vast and varied that it is difficult to specify the causes with any percentages applicable to the country as a whole. Further, the owners of business give one opinion as to the most important cause of failure, while the creditors rank the causes of failures in quite a different order. Their views and opinions are not altogether unbiased. So, we will glance through the opinions of different men in this field. A study of many failures and the reasons for their occurrences provides facts which must necessarily be considered before preventive and remedial measures can be formulated.

Different causes and opinions:

Victor Sadd and Robert T. Williams made a study<sup>1</sup> of the causes of failures among many different kinds of business enterprises near Boston. The period covered was from November 1930 to June 1931. They rank the causes as follows:

<u>Cause of Failure (owner's opinions)</u>	<u>Percentage of Enterprises Affected</u>
Business depression	67.7
Insufficient capital	48.2
Competition	37.9

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1. Sadd, V. and Williams, R. T. "Causes of Commercial Bankruptcies" Domestic Commerce Series No. 69. P. 14.

Cause of Failure (owner's opinions)	Percentage of Enterprises Affected
Adverse domestic and personal factors	35.1
Decline in value of assets	31.6
Bad debt losses	29.8
Inefficient management	28.2
Excessive overhead expenses	24.0
Poor business location	14.6
Losses from speculation	11.6
Unfavorable changes in trading area	11.2
Excessive interest charges on borrowed capital	11.1
Too rapid expansion	10.5
Losses from signing notes with recourse	9.6
Buying too much on credit	9.5
Real estate losses	6.1
Lack of adequate books	5.6
Automobile-accident losses	2.5
Failure to carry sufficient insurance	2.3
Unusual expenses	1.8
Inefficient and dishonest employees	.9

Causes of Failures (creditor's opinions)	
Inefficient management	58.7
Dishonesty and fraud	33.7
Insufficient capital	32.9
Business depression	29.1

Causes of Failures (creditor's opinions)	Percentage of Enterprises Affected
Adverse domestic and personal factors	28.1
Bad debt losses	17.6
Competition	9.1
Excessive overhead	8.9
Too rapid expansion	7.2
Decline in value of assets	5.8
Losses from speculation	5.8
Buying too much on credit	3.9
Poor business location	2.7
Decline in rental income	2.3
Lack of adequate books	2.1
Excessive interest charges on borrowed capital	2.1
Unfavorable charges in trading area	1.9
Signing notes with recourse	1.4
Real-estate losses	1.4
Unusual expenses	1.4
Failure to carry sufficient insurance	.7
Automobile accident judgments	.6
Inefficient and dishonest employees	.6

According to their report, more than 51 percent of the concerns had no accounting records. But of a total of 570 bankrupts, 360 reported that they had not obtained any business information or advice from such sources as

credit bureaus or trade associations. In more than 68 percent of the bankrupt businesses, the owners or the managers had not completed a high-school education.

Foulke of Dun and Bradstreet, Inc.<sup>1</sup> writes that the following causes are responsible for business failures:

business incompetence,  
lack of net working capital,  
undue extension of credit to poor risks,  
unusual competition,  
physical disasters such as floods, fires, and un-  
seasonable weather,  
over-trading and under-trading,  
personal extravagance of partners and officers,  
speculation and even that most abused of all in-  
tangible impersonal reasons, "general business  
conditions".

An analysis of the causes of failures of retail drug stores based on a study<sup>2</sup> of 30 cases, reveals the following causes:

1. Insufficient capital.
2. Inexperience.
3. High rent.

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1. Foulke, R. A. "Behind the Scenes of Business" p. 65.  
2. Domestic Commerce Series No. 59. pp. 4-12.

4. Bad business location.
5. Poor business management, i.e.
  - a. No adequate accounting records.
  - b. No inventory or rate of turnover.
  - c. Misuse of place by friends.
  - d. Oral statements instead of written contracts.
  - e. Free use of money by family members.
6. Dishonesty.
7. Bad debt losses.
8. Business depression.
9. Changes in the neighborhood.
10. Competition and illness.

Other causes: rapid expansion, more expense, no insurance, bad personal habits, poor personality, inefficient and dishonest help.

The Economic Principles Commission of the National Association of Manufacturers<sup>1</sup> says that, unfortunately, a substantial percentage of new business ventures do not prove successful; and there are many reasons for this, but among the most important may be mentioned the following:

Bad management.

Bad location.

Insufficient capital.

Poor products.

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1. Economic Principles Commission of NAM, "The American Individual Enterprise System". Vol. I. p. 33.

Inefficient production.  
Inefficient marketing.  
Depressed business conditions.  
Exorbitant labor demands.  
Governmental restrictions.  
International disorganization.  
Attempting to cover too much territory.  
Inadequate accounting.  
Bad planning.

Another study made by Ulmer<sup>1</sup> in 1946 -- the period of reconversion -- shows that 47 percent of failures were due to scarcity of merchandise and materials, 28 percent due to labor shortage, 16 percent due to rise in labor cost, 13 percent due to lack of customers, 12 percent due to lack of capital, 10 percent due to rise in rent, 8 percent due to equipment and repair scarcity, 2 percent due to decline in value of inventory, and 13 percent due to other causes.

Harmon Wilson of Southwestern Publishing Company of Cincinnati cited the following, as causes of business failure, when he made his speech at Michigan State College in 1948:

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1. Ulmer, M. J. and Nielsen, A., "Business Turnover and Causes of Failure," Survey of Current Business, April, 1947. p. 3.

1. Lack of capital and knowledge of how to finance a business,
2. Inability to select the good location for business,
3. More overhead expenses, and lack of understanding of cash versus profit,
4. Lack of knowledge of products,
5. Inability to establish satisfactory source of supply,
6. Failure to know all things, while buying an already established enterprise,
7. Inflated opinion of ability to operate a business,
8. Inexperience in making a market analysis to pre-determine estimated sales and profit potentials,
9. Lack of knowledge of setting up an operating budget,
10. Lack of knowledge in handling personnel and good public relations.

As mentioned before, these causes vary from business to business, and from place to place. This study will not establish any ranking of the causes of business failures in the order of importance. The causes are more than one for each failure. Some of the causes are very common factors that contribute to business failure, while some factors 'are in the main environmental, reflect the characteristics of the current business situation' and may proximately

lead to failure.<sup>1</sup> The causes are here divided into "permanent" and "temporary" causes.

Permanent causes are those causes, which are ever present in business, and act as the underlying cause of failure. They will be called permanent or fundamental causes. Temporary causes as opposed to permanent causes arise incidentally or gradually, stay for a temporary period, and topple enterprises or hasten business failures.

A. Permanent Causes:

✓ 1. Inefficient Management: This means the unprofitable and unsuccessful conduct of a business, due to lack of training, experience, ability, adaptation, or enterprise of its managers. This is supposed to be the major cause for many business failures. Many other causes can be included under this head, because many failures could be averted, if the management was intelligent and experienced in making any business policy or judgment.

Inefficiency may take many forms: "bad location of business, overbuying, poor selection of goods, slow rate of stock turnover, selection of incompetent employees, inadequate supervision of employees, bad salesmanship, poor advertising, unwise extension of credit, failure to

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1. Ulmer, M. J. and Nielsen, "Business Turnover and Causes of Failure" Survey of Current Business, April, 1947. p. 2.



collect accounts, failure to keep adequate records, pricing goods too low or too high, extravagance or dishonesty."<sup>1</sup>

As Foulke of Dun and Bradstreet says, for every business enterprise which fails, the managements of a greater number close up shop, lock the windows, turn out the lights, pay the rent, liquidate their bills, and then voluntarily move on to try their fortune at some other location, or to become employees, until they can husband sufficient resources to become entrepreneurs once again. Too many persons venture into business without a true valuation of their own abilities and a knowledge of methods required to conduct a business profitably. Ulmer makes the statement, that about 1/5 of the failures in 1946 are those of veterans of World War II, who engaged in business upon their return from military service.

Here it may be pointed out, that competition and freedom of business enterprise are foundation stones of the present economic order. An economic system based on these principles is, generally, believed to be more desirable than any alternative plan for the United States of America. With all the numerous and far-reaching advantages of competition and economic freedom, however, there are certain adverse factors. One of them at the

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1. Converse, P. D. "Should I Start My Own Business" Special bulletin No. 5. p. 43.



present time is the high mortality rate among business organizations. Many people, whether qualified or unqualified, enter into business, when they have no other job, and increase business failure.

The seriousness of inefficient, and therefore ineffective, executive management of business is reflected in the findings of causes of business failures. "The concern under sound aggressive management weathers the storm, but the one under weak, unskillful management joins the daily obituary list of business enterprises."<sup>1</sup>

While the government requires the lawyers, doctors, barbers, etc., to pass examinations in the interest of public welfare before they enter into their business, similar examinations are not given to every business man, although the need is both apparent and pressing to reduce business failures and to increase the efficiency of business men. This question of examination to every business man will be discussed in a later chapter.

## 2. Bad Accounting and High Expenses:

Inadequate record-keeping is a serious factor in business failures. Nearly two-fifths of all firms, which were liquidated or sold in 1946, did not prepare annual

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1. Foulke, R. A. "The Sinews of American Commerce" Dun & Bradstreet, Inc. New York, 1941. P. 379.

profit-and-loss statements. An annual profit-and-loss statement, along with the running accounts of expenses, receipts, and inventories which such a statement entails, provides a generally recognized key to the existence of accounting records required for efficient management.

Many business executives suffer under the load of high operating expenses. Major operating costs, which are higher than the average for similar successful enterprises, should be regarded as an indication of a likely failure. Unless rent and salaries, usually the two largest overhead expenses in the majority of businesses, are in proportion to the volume of sales, failure is imminent. The profit and loss statement reflects the efficiency of management; and the appearance of excessive overhead costs is an indication of inefficient management, and possible failure.

The accounting records of a certain company<sup>1</sup> for the three years preceding failure reveal the following data:

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1. Source: Domestic Commerce Series No. 69. p. 18.



Item	1st Year	2nd Year	3rd Year
Net sales	\$588,049.81	\$593,570.69	\$551,161.75
Cost of goods sold	<u>420,197.45</u>	<u>391,413.42</u>	<u>489,964.97</u>
Gross profit on sales	167,852.36	202,157.27	61,196.78
Operating expenses	<u>165,588.26</u>	<u>164,918.61</u>	<u>153,358.16</u>
Net profit or loss on operations	<u>/2,264.10</u>	<u>/37,238.66</u>	<u>-92,161.38</u>
Bad debt losses	1,269.18	18,006.85	12,674.92
Other adm. expenses	<u>17,614.00</u>	<u>17,892.01</u>	<u>20,316.78</u>
Profit or loss	-16,619.08	<u>/1,279.80</u>	-125,153.08
Other income	<u>3,790.82</u>	<u>3,795.22</u>	<u>5,272.17</u>
Total profit or loss	-12,828.26	<u>/5,075.02</u>	-119,880.91

This record of the company gives us an idea of how loss is incurred by high operating and overhead expenses, and unwise extension of credit, although the sales were fairly good.

### 3. Bad debt losses:

"The entire credit system is a delicate commercial mechanism, easily disrupted by injudicious usage. The failure of one individual or concern to pay just debts on the due date adversely affects, however remotely, all members of the vast credit system."<sup>1</sup> The consumer must

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1. Sadd and Williams, "Causes of Commercial Bankruptcies" p. 21.

pay the retailer, and the retailer must pay the wholesaler, before the latter can pay his creditors. Upon the soundness of credit granting by the retailers, the wholesalers, the manufacturers or the bankers, depends the soundness of the entire merchantile structure.

A true appraisal of ability and character is necessary in every credit transaction. The many errors made, are reflected in the appalling credit losses and business failures. A bad debt loss is, usually, nothing more or less than the result of an error in judgment. A consumer or the operator of a business is no longer a "mysterious stranger" in the commercial community. Evidences of debtor's capacity, character and capital can be secured from many authentic sources. The negligence of a creditor to base credit extension on facts, systematically gathered from all available sources may result in his own failure and the failure of others.

Reports from 1,371 independent retail grocery stores in Philadelphia, representing all sizes of stores and all sections of the city, (with total annual net sales of \$29,425,041) show that 40 percent of total sales were made on credit. Of the total of 1,371 stores, 294 or 21.4 percent sold for cash only, and 1,077 or 78.6 percent sold

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1. Plummer, W. C. and Ritter, P. O. "Credit Extension and Causes of Failure Among Philadelphia Grocers". p. 1.

for both cash and credit.

In this connection, sellers must bear some of the responsibility for the failure of their customers. High pressure salesmanship has caused many a small retailer to overstock his inventory, or buy merchandise that he could not easily dispose of. Over-liberal credit terms may facilitate such excessive buying, and further contribute to the accumulation of an excessive burden of liabilities. "Of course, it is inefficient management on the part of the store keeper, to allow himself to be oversold in this manner. But the sellers, and the credit managers of these sellers, who have collaborated in this overselling, can not fairly place all the blame for subsequent failure upon the store keeper to whose disaster they contributed."<sup>1</sup>

Liberal creditors, who are influenced in their decisions by an insatiable desire for a larger volume of business, actually, encourage many undeserving debtors to accept an unwarranted amount of credit. A close analysis of the causes of bankruptcy by Sadd and Williams, discloses the fact that over-buying is a frequent cause. Every debtor is confronted with the problem of accepting or rejecting what appears to be an endless succession of "attractive propositions" presented by persuasive salesmen

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1. Shultz, W. J. "Credit and Collection Management". p. 471.



who insist that the signature to the order is all that is necessary to complete the transaction. The inefficient credit manager, when confronted with the debtor's order, will probably accept the assurance of the salesman that the account is a very desirable one which, if rejected, will undoubtedly be accepted by competitors.

Many of the necessary factors which should be considered in the granting of credit, are ignored to prevent the firm's competitors from securing the order. The data collected on the use of a credit bureau in carrying on credit business show that, as a rule, the stores which used a credit bureau, had fewer bad debts than those which did not.<sup>1</sup>

Another hindrance to effective credit management is the fear of losing a debtor's goodwill, which restrains many credit managers from making a thorough investigation before extending credit. Most debtors, especially the poor risks, resent a thorough investigation of their affairs and competency, which might prove the advisability of accepting the credit offered by enthusiastic salesmen striving only for larger sales commissions. Laxity in credit extension also encourages the debtors to live beyond their means, and tends to increase extravagance.

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1. Plummer, W. C. "Credit Extension and Business Failures". p. 14.

#### 4. Insufficient Capital:

Closely allied to the matter of unwise extension of credit is the fact that insufficient capital is a frequent cause of business failure. In other words, many concerns attempted to do too much business on credit.

An able and ambitious business man, operating with a moderate capital sufficient for the scope of his current activity, foresees a larger business and greater profits, if he expands the scope of his operations. Suppose, he does so without drawing additional capital into the business, perhaps, by renting larger premises, perhaps, by purchasing a larger inventory on credit terms, perhaps, by purchasing more equipment on the instalment plan -- probably by a combination of all three. His capital, which provided an ample buffer for his previous smaller volume of obligations, becomes too thin in proportion to the increased volume he has assumed. Given time, his energy and ability will produce profits which can be plowed back into the business, and build up its capital position to a point consonant with its enlarged scope. But such time is not always given. Some one of his judgments may be mistaken and involve him in a loss too large to be absorbed in his new vulnerable position; or external circumstances may operate against him, before he has had time to build up his capital buffer. He becomes one more name in the tabulations of the year's business failures.

Some people have their capital heavily tied up in inventories or equipment, with a consequent shortage of working capital. The inability to convert merchandise and receivables into cash with which to pay operating costs, and credit obligations as they accrue, is often the result of uneconomic organization of the capital available rather than lack of capital. Frequently a business organized without sufficient capital, and lacking the necessary margin of financial safety, is wiped out, when it is unable to overcome adverse conditions. Many concerns carry on operations inconsistent with their resources or prospects for profits; and when expected sales do not materialize, a shortage of funds results. Without adequate reserves to meet creditors' claims, these concerns are forced to secure an extension of credit or to liquidate their business for the benefit of creditors. In such cases, the owners or managers, generally state that the cause of failure was the lack of ability to manage effectively the capital available for use.

It is worth mentioning here to say that the Reconstruction Finance Corporation, established in 1932, has assisted many businesses with loans. During the early and middle 1930's, this corporation provided the capital necessary to keep many business firms in operation. "From February 2, 1932 to December 31, 1948, the Reconstruction Finance Corporation made disbursements of \$36,406,917,400".<sup>1</sup> It also

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1. Craf, J. R. "An Introduction to Business Principles and Practices." p. 524.



seems desirable to start a business mostly from personal savings and ownership contributions of shareholders rather than by borrowing over 50 percent of the needed capital.

To sum up, the permanent causes are (1) inefficient management, (2) bad accounting and high expenses, (3) bad debt loss, and (4) insufficient capital. They are considered to be very vital factors for any business man who enters business or who is already engaged in a successful business. If they pay more attention to avoiding these bad practices which are fundamental causes of failure, it can be said that the chances of failure are greatly reduced.

There are also some temporary causes which are responsible for business failures; and they are discussed below.

#### B. Temporary Causes:

Some causes of failure arise out of adverse circumstances and conditions, which are not possible for the entrepreneur to foresee accurately, or cope with successfully. We have already pointed out that most failures are not inevitable results of a series of external misfortunes. And we have seen that the individual or the manager himself has many flaws in conducting his business, and that such flaws may be directly responsible for the ruin of his enterprise. An unfortunate event, like fire, flood and storm, is generally the occasion rather than the cause of failure.

Yet, such events are called temporary causes, because they arise incidentally or gradually, remain for a more or less temporary period, and operating with a force beyond the individual's control, topple enterprises or hasten business failures.

#### 1. Business Depression.

Many people say that most failures are accounted for by the "business depression". To understand "business depression", we set down here a brief note on business cycles.

Business activity in the United States is characterized by what may be termed cycles. Economically, we move through depression, recovery, prosperity, and recession, and then back to depression. These cycles have been in evidence since the establishment of the country, and are for that matter characteristic of the economies of many other countries.

During a period of depression, there is mass unemployment, numerous factory sites are idle, prices are low, inventories are liquidated, morale is at low ebb, and the government creates employment through public works projects. As recovery is made from a period of low business activity, heavy industries, such as construction, steel, and cement, begin to show increased activity, private employment begins to pick up, public works projects are decreased, and

business failures decrease. During the prosperity phase of business activity, employment increases, goods are produced in quantity, prices increase, wage demands are numerous, profits rise, and productive facilities, particularly in heavy industries, are expanded. So this cycle of prosperity continues, goods tend to be over-produced, increased wages and costs of production continue to be heavy, and consumer resistance to high prices finally becomes evident. Both industrial and ultimate consumers tend to become cautious, reduce purchases, and buy in more limited quantities. As purchases at the consumer level are slowed and as industrial users of goods and services become cautious, inventories begin to pile up and unemployment rises. Recession then evidences itself, and the period of recession or crisis returns.

So, business depression is the period in the business cycle that follows recession in the down-swing of the cycle. It is also characterized by a maladjustment of various economic factors. "It is one of the truisms of the economic world that business failures suddenly and tragically expand during a depression, like helium gas in a stratosphere balloon in the warmth of the morning sun."<sup>1</sup> During the period of depression, business men must be careful in buying

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1. Foulke, R. A. "Behind the Scenes of Business." p. 138.

and selling goods, constantly watching the market trends and business conditions. There will be an acid test for the management to find the worth of its efficiency at that time.

Many people say that most failures are caused by the "business depression". But the cause of failure in most cases, at that period, may not necessarily be "business depression". During the years 1927 and 1928, a period of boom prosperity in the opinions of many, approximately 47,000 concerns failed with a loss to creditors. During 1929 and 1930, a period in which the characteristics of a depression were in evidence, slightly over 49,000 failures were recorded by Dun and Bradstreet, Inc. These periods of prosperity and depression fail to disclose any pronounced difference in the number of business failures, although some difference does exist. The large number of failures occurring prior to 1929, must be attributed to something other than "business depression".

Every business failure study made in the past has proved that other causes were more fundamental and influential than business depression. It is probably that the larger proportion of failures results from bad judgment shown at the very inception of business. The greater number of enterprises, which are launched, and later fail, have no economic justification for existence, and lack the essentials of successful operation. In most cases, it could hardly be





expected that anything short of a miracle would enable them to avoid failure, and a temporary lull in business activities serves only to accelerate the movement toward an inevitable end.

The following case<sup>1</sup> is given for further illustration on this point:

This case involved a corporation, manufacturing dresses, which started in business in 1923 with \$11,000 paid-up capital. In 1926, the authorized capital stock was increased, and by 1927, they had \$81,000 paid in. Garments were made to sell for \$16.50 to \$50 a dozen, of which 60 percent was cost price, completed, and 40 percent allowed for selling expenses. The general policy was to allow \$2 to \$5 a dozen for overhead. The owners of the business claimed that business depression was the major cause of failure. Yet in the years 1926 to 1930, goods were frequently sold below cost. An analysis of the accounting records revealed, that in 1926, net sales were \$44,815, on which a loss of \$32,000 was sustained. In 1929 gross sales were \$30,415, and returns and allowances were \$6,030, or 20 percent. Cost of goods sold was \$24,289, selling and administrative expenses were \$12,000. Total expenses plus cost of goods sold were, therefore, \$11,904 more than net

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1. Sadd, V. and Williams, R. T. "Causes of Commercial Bankruptcies." Case No. 173. p. 19.

sales. The net operating loss was \$14,031 for 1930, the last year in business.

It appears that this concern operated without sufficient knowledge of total operating costs, and that such costs were greater than they should have been to allow sufficient margin between sales and cost of sales to absorb selling and administrative expenses, and leave a margin of net profit. While the officers of the corporation thought that business depression was the principal cause of their failure, it is obvious that other more fundamental reasons caused the failure.

Further, the business failures can be reduced during a depression if business men are educated on the different periods of business cycles. "No doubt cycles will have to continue as warnings, like occasional outbreaks of typhoid and smallpox. Alternate waves of recklessness and repentance will still bring them as long as human nature remains what it is. But if once the mass of men become cycle-minded, just as they are already sanitation-minded, even minor booms and depressions will keep them alert to the need for caution."<sup>1</sup>

## 2. Decline in value of assets:

The rapid decline in the values of merchandise, real

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1. Towle, H. L. "Business Cycles and Business Men", Scribner's Magazine, June, 1936. p. 367.

estate, equipment, and other assets occur sometimes due to bad business conditions and this has undoubtedly been a contributing cause of business failures. As mentioned before, this is not a permanent cause of failure.

The decline in value of assets has not been offset by a corresponding reduction in amount of liabilities accrued against the depreciated assets, and concerns without adequate reserves are forced to extreme measures in order to pay creditors. Shrinking values threaten the business structure; but if the managements build up sufficient reserves, when the values are increasing, or allot certain amounts every year for that purpose, failure due to decline in value of assets can be avoided. Speculators should be warned of causing extreme price changes of commodities.

### 3. Bad location:

This is an important factor for most retail stores. Considerable study has been devoted to the subject of store location, but "the evaluation of specific locations is far from an exact science."<sup>1</sup> There are two aspects of store location: (a) an analysis of the business available in the trade area of the proposed store, by taking into account the population, the income, habits and occupations of the residents, and local climate; and (b) the selection of a

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1. Converse, P. D. "Should I Start My Own Business", Special Bulletin No. 5, p. 36.



specific location for the store, giving due consideration to the type of store, traffic movement and density, parking facilities and area of space required.

Business failure research has revealed that many failures occur with periodic regularity in the same business locality, and often on the same site.<sup>1</sup> In that respect it will be a permanent cause. A typical example is that of a particular site in St. Louis, where three owners of a drug store failed within a period of four years.<sup>2</sup>

But it happens that a good location turns out to be a bad location and vice versa, due to population shifts, transportation facilities, and communications. In a study of the growth and decline of South Dakota trade centers, Landis<sup>3</sup> points out, that the rapid growth in railroads was reflected in the growth of trade centers; and that there seems to have been an inverse relationship between the development of the automobiles and improved highways. Certain institutions frequently cause trade centers to develop beyond what would be warranted. For instance, the possession of Michigan State College has led to the growth of a town called East Lansing.

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1. Domestic Commerce Series No. 59. p. 22.

2. Ibid.

3. Landis, P. H. "The Growth and Decline of South Dakota Trade Centers, 1901-1933". p. 33.



#### 4. Business Changes and Improvements:

To ignore business changes and improvements will lead to business failures. In every phase of economic activity, the process of progressive change is never-ending. Although the individual business man has little influence in determining or controlling any or all of the many changes taking place, he should be intelligent with respect to them; and particularly he must be intelligent with respect to the changes taking place in his own field of endeavor. In this modern competitive business world, new inventions, ideas and methods are constantly being forced into use. The methods of production and of distribution undergo frequent revolutionary changes, and the consequent effects are disastrous to many business men, who are slow to heed, and to conform to inevitable economic transitions.

Some changes apparently have no conceivable bearing upon the enterprises effected, and the business man must always be alert to discern and understand the variable factors over which he has little or no control. Certain happenings result in price changes; some brought on by his own actions, some brought about by the action of his competitors; and some forced upon both him and his competitors by events that are shaped by the collective but unconscious efforts of all consumers. The slightest misjudgment of the actual course of events often means for the business but one outcome, failure.



##### 5. Adverse Domestic and Personal Factors:

Many people say that the inability to overcome bad personal habits is the primary cause of failure. Extravagance, intemperance, indolence, gambling, and other related habits are frequently mentioned by the debtors, as the origin of their difficulties. In some instances, members of the entrepreneur's family may be at fault, and their wasteful habits will ruin the business.

The health of a business man is an important determinant of his success. Prolonged sickness and accumulated doctor bills may cripple a successful business to failure. It is not necessary to subject a credit applicant to a physical examination in order to determine his credit worthiness, but to ignore obvious evidences of long ill-health is to disregard an indication and warning of probable failure.

##### 6. Inefficient and dishonest employees:

Inefficiency and dishonesty of employees are responsible for numerous failures. This is because the store personnel may be appointed without proper selection and training, or he may not receive enough incentive, or he may have some grudge against the boss, or he may have some domestic troubles and personal worries, or even greed for wealth. Withdrawals of merchandise or money from the stores by the employees have sometimes been a primary or contributing cause of failure. Employees who are discourteous and

inattentive to customers will cause a certain reduction in volume of sales, and endanger the stability of the business. Creditors, who invest money or merchandise in an establishment, and fail to consider the type and character of the employees of that establishment, neglect to heed an obvious signal of possible failure.

#### 7. Other Causes:

There are some other causes that put an end to business structures. These causes can not be prevented easily, and they arise occasionally. For instance, flood and storm do a great damage to merchants while the goods are in transit. The losses due to such acts of God, and other unfortunate events like fire, theft, riot and strike, are great. Although it is hard to prevent such occurrences, it is possible to reduce the losses or compensate for losses of that nature by taking out an insurance policy. Most of the losses are covered by the insurance companies.

The premature death of an enterpriser, or the retirement of an experienced business man without a proper heir to succeed his business may cause trouble to the successful business. Here it will be desirable to hear Taussig of Harvard University about heredity and its influence in business.

"Business leaders are recruited in the greater part from well-to-do classes; business leaders of the present genera-



tion are, for the most part, the sons of business leaders of the preceding generation; and within this inbreeding group of business leaders, the ownership and management of identical business concerns are handed down from father to son."<sup>1</sup>

No doubt, experience and heredity have great influence in running a business successfully. But, at the same time, it will not be impossible for the son of a laborer or farmer to get the necessary training and run the business gainfully.

Scarcity of materials and labor shortage will be prominent causes during any emergency of war. These causes forced many concerns to quit business during World War II.

Thus the temporary causes have been described here under different headings: (1) Business depression, (2) Decline in value of assets, (3) Bad location, (4) Business changes and improvements, (5) Adverse domestic and personal factors, (6) Inefficient and dishonest employees, and (7) Other causes. It is hoped that these causes, permanent and temporary, described in this chapter will act as warning signals to those business men who enter business newly or who are already in business.

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1. Taussig, F. W. "American Business Leaders" p. 236.

#### IV. EFFECTS OF BUSINESS FAILURES

One may wonder what are the effects of business failures. When a business fails in a legal sense, its assets will be sold for what they will currently bring; and the final result of the liquidation of the enterprise is, in many cases, at least a partial loss of creditors' claims. Of course, the foremost sufferer is the proprietor himself who is deprived of an operating enterprise, and who loses financially all or a large part of his equity. The loss to the owner and his creditors is evident. It is true that competition in a free enterprise system weeds out the inefficient and weak persons from those who are better fitted to carry on business.

Now how does the financial loss resulting from failures affect the economy of the country? What is the fate of those who are thrown out of business, and how do they get along in this world? What are the other effects? These questions are considered while thinking of business failure, and an attempt is made to give a few answers to them.

##### Economic effects:

It should be remembered that each individual is part of the society in a country. The losses suffered by each individual will affect the economic structure of the country to a certain extent. The billions of dollars lost by owners

and creditors of failed concerns, and bankrupt individuals form only a portion of the total resulting losses. No representative estimate of the aggregate losses resulting from failures can be made; yet it is evident, after a consideration of the widespread effects on numerous groups of individuals and the economic system in general, that such losses are incredibly large.

These losses are seriously detrimental to the public interest, and to the economic welfare of the nation. Capital is wasted in unprofitable and unsuccessful ventures by incompetent and incapable business men. The loss of a normal rate of interest on wasted capital must be included in the total waste resulting from business failures, and this total waste certainly retards the increase of national wealth.

#### Social effects:

When debts are contracted beyond ability to pay, and later are annulled in the bankruptcy courts, it is obvious that respect for private contract rights has been destroyed, and that the integrity of individuals no longer assures the payment of an honest debt. The bankrupts often lose their friendship and goodwill from their creditors, and frequently find no jobs with which to make their living. In many cases, the communities in which failures occur are forced to provide food and shelter for those unable to secure employment or assistance from other individuals. This means a social

burden to the community. The total income of the community is decreased, and the collective prosperity of its inhabitants is adversely affected. All failures involve losses which, in the final analysis, are borne by the public. Even if the government spends for the protection of these unfortunate individuals, she spends the money collected by way of taxes from the public.

The discontinuance of a business involves a keen hardship on its employees. They are forced out of employment, and their purchasing power is reduced. The reduction of their purchasing power -- even if it is only temporary -- is injurious to their welfare and to the welfare of the community in which they reside. Many are fortunate enough to find other positions readily, if work is available. If, however, a period of unemployment follows, the workers' connection with a bankrupt concern often increases their difficulty, because many wage earners have invested a portion of their savings in the failed enterprise, and they lose those in addition to their positions. The total losses suffered by employees can not be estimated, yet it is certain that they are tremendous.

It should be remembered that state unemployment insurance provides the unemployed worker with financial help for a given period. If the employer before becoming a bankrupt, had paid the taxes for unemployment insurance, the sufferings of his employees, in case he becomes bankrupt,





would have been reduced.

Other effects:

It would appear, that competitors of failed establishments would profit by their non-survival. On the contrary, they may be forced to accept losses, which, in many cases, are sufficient to wipe out profits and threaten their own solvency.

Suppose there are five business failures in a particular trading center, and they are settled by bankruptcy courts. Then, the assets of these five failed concerns will be sold at whatever prices they are able to command. In other words, they are sold at auction. These sales, which are being conducted in the same trading center, often in the same block, frequently prevent the maintenance of a necessary profit margin in an active business. Until the merchandise of these bankrupt businesses is sold, the active merchant must compete against the bankruptcy sales. An auctioneer or trustee is forced by clamoring creditors (who are eager to get at least 10 cents on every dollar due) to dispose of merchandise at any price he can get. The consumer naturally buys where he can obtain the best bargain, and such bankruptcy sales are well attended. The owner of an existing concern cannot reduce the costs of doing business sufficiently to offset the loss of trade. His wages, rent, and other overhead costs must be paid. It is not unusual, therefore, for an otherwise stable business to be-

come insolvent after attempting to survive in a local market demoralized by a series of bankruptcy sales at which the buyer sets the price.

Another minor effect is also felt by some. Customers, who were benefited by the low prices and goodwill of the failed concern, have to find a new supplier for the goods they need.

The reduction of national wealth, the social burden to the community, and the plight of the employees are some of the important effects which will stimulate the reader to go deep into this matter, and endeavor to study means of preventing business failures and their bad effects on both the community and the country.



## V. PREVENTION

The causes of business failures are numerous, and the effects and consequences of failures are considered to be serious. After knowing the causes and effects, it is felt necessary to propose some remedial measures to prevent failures. Three alternative proposals are made, first, to examine the people before entering business, second, to regulate and restrict the number of people entering business, or third, to educate the general public on good business principles and practices.

### Examinations:

In suggesting examinations for prospective business men, a brief explanation is given as to why they should take those examinations.

It was seen that most of the causes of failures can be summed up in two words "Inefficient Management". Management consists in the individual or the group of persons who exercise leadership, and who are able to determine, clarify and effectuate the purposes and objectives of a particular business. It may be "administrative management" which formulates the policy, or "the operating management" which executes that policy.<sup>1</sup> In reality no clear-cut line of demarcation, can be drawn between those who make policies,

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1. Peterson, E. & Plowman, E. G. "Business Organization and Management" P. 33.



and those who execute them. If the business is conducted unprofitably and unsuccessfully by people without enough knowledge, training, experience, and adaptability, then it has "inefficient management".

The captain of a ship directs and manages his craft so that it will sail well, in spite of high tides and dense clouds on the ocean, thereby he avoids any shipwreck, and reaches his destination successfully without damage to his boat, men and materials. This shows the efficiency of the experienced captain of the ship. Similarly every business can be run successfully, provided the entrepreneur or the manager uses his intelligence and experience, and takes necessary precautions, when the economic clouds cover the business world, and cause trouble to business men.

A Russian visiting the United States was asked to compare the two countries. He replied that every American expected to start a business of his own, whereas in Russia there was no such opportunity. It is, of course, an exaggeration to say that every American expects to start a business of his own. This just shows that the Americans have more freedom than the Russians. But any ambitious youth with industry, average intelligence, and thrift can save enough money to start a small business; and if he has real initiative and imagination to sell his goods and find new methods of improving his business, and the ability to forecast sales and price changes in the market, and to know

the public mind, then he can develop it into a profitable business of considerable size.

Considering the large number of business failures and the short life of most business enterprises, why should anyone aspire to start a business of his own? There are two main reasons: First, some men crave the greater opportunities for profits and self-expression, and the satisfaction of accomplishment which can not be found in working for others; and they take pride in being their own bosses. Second, if a man is out of work and unable to get a job, he may decide to make a job for himself.

In general, our form of government interposes no check on persons entering business. Many unqualified persons enter into business without knowing the principle of their business. Of course, many cities require plumbers, barbers, and electricians to know the elements of their trade before they can obtain a license, and every state requires doctors and lawyers to pass examinations. Examinations for those desiring to enter the insurance or real estate businesses are not new.<sup>1</sup> They are all given in the interest of public welfare, health and safety of the people at large. It was pointed out in the previous chapter that capital is being wasted by unsuccessful business men

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1. Converse and Huegy. "The Elements of Marketing". p. 543.

and it also retards the national wealth. In other words, economic health of the nation is impaired to a certain extent, by the act of incapable persons going into business. Examination for every business man will be a step in the right direction, and it will have the effect of preventing unqualified persons from entering business, and will have the tendency of increasing the efficiency of business men to do successful business for a considerable number of years.

The proposed examination will cover the elementary principles of merchandising and accounting. This will be held in recognized schools and colleges of the country. Every prospective business man or executive should be required to pass an examination of this sort given in one of those certified institutions, before he enters into a new business, or before he joins a business corporation. Under this proposal, those wanting to establish a business would have to study the elements for business, or secure enough practical experience to pass the examination. It is hoped that this method will increase the efficiency of business men in conducting business and in stabilizing business units.

These tests may not necessarily be the best way to judge the ability of an enterpriser. Besides knowledge, one must have good health and good personality to work and get along with people. He should have courage and



"commercial instinct", the ability to sense values and the willingness to take chances. These traits can not be correctly judged by holding examinations only. Experience plus examination will hold a business man in good stead. At the same time, it can not be denied, that holding examinations has the merit of increasing the efficiency of business men; and this would, to some extent, prevent unqualified persons from entering the business and increasing the death toll of business.

Government regulations:

A trend toward multiplying the rules and regulations of government in a number of fields is increasing. Much of this is inevitable. The more complicated a society becomes, the more necessary it is that government acting in its minimum capacity of setting the rules of the game, must extend its field. The game of today involves many more people, and affects their interests in much more direct ways, than in the past. Even if a government were completely committed to the preservation of individual liberties and individual freedom of action, it would be necessary that the book of rules be expanded. These facts often create a necessity of limiting the immediate freedom of action of others. The necessity for sanitary regulations, and the need for red and green lights on heavy traffic roads are simple and obvious instances. There is nothing new or startling in this. "The founding



fathers of this government recognized that liberties had to be curtailed at some points to preserve them at other more important points."<sup>1</sup>

An individual might have passed an examination, and accumulated savings to start a business. Before he invests his savings in a business, he must make a wise decision as to what kind of business he is going to enter, why, where and how. These are the fundamental questions raised before starting up a new firm. A real need for his product or service should be shown by the residents of locality where the new firm is to be established. After the need has been realized, the approximate cost of his product or service should be determined to cover up his expenses. Adding up his profit, the price should be compared with the prevailing price in the market. The ambitious individual should also find a plausible answer to the question, "In what way is he going to reduce his cost of the product or improve his service when compared with his already existing competitors?"

Without giving consideration to those facts, people simply start a business, when they have no other work; and they increase competition and wreck some business men. For example, if the population of a community warrants no

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1. Griffin, C. E. "Enterprise in a Free Society" p. 267.

more than five eating places, the sixth entry in the same business will be a sort of danger signal to all the owners of eating places in that community. And a seventh entry will hasten the failure of one or two establishments in that locality. Unless the new firms start with adequate funds, modern equipment, and tolerable prices, they will die soon in the first year, or else one or two of the already established weak and old firms are bound to quit, because of more supply and less demand, and hence low prices and less profits.

In order to prevent such over-supply of stores of similar trade at one place, the government regulation is deemed necessary. Here the government will have to do market analysis for all trades and plan how much maximum business is possible in each area, and then limit the people who go into that business. As told in the previous paragraph, the government should allow five stores at different corners to serve the community. This kind of government regulation will not attempt to give room for a monopolist of any trade, but will work to improve the business methods and to reduce business failures. It is hoped that the government will allow the right people to enter into the right business at the right time and place. Regular auditing of accounts will be made by state officials, and necessary advice and help will be forth-coming from them to do better business.

While the government regulates the business, she must encourage business research by producers, consumers, colleges and other institutions and make the results available to all merchants. The immediate and primary need of business today can be met only by business research because of the following logical reasons advanced by Duncan:<sup>1</sup>

1. The immediate and primary need of business today is intelligent direction and control generally.
2. Intelligent direction and control of business can be had only by a better knowledge of business principles.
3. A better knowledge of business principles can be derived from a careful and comprehensive survey of business facts.
4. To secure a careful and comprehensive survey of business facts is a problem for business research.

People may say that this kind of business regulation by the government will not be desirable for American economy, and it will be possible only in a society where there is "planned economy". The suggestion of government control is opposed to the idea of "equal opportunities to all", and suggests the danger of "favoritism". When there are more than five people who can run eating places in a

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1. Duncan, C. S. "Commercial Research" p. 5.

community, it is pretty hard to select and allow only five. Red-tapism and bribery may result in government offices. Further unemployment problems will increase, and the government will have to provide more relief to the jobless adventurers.

#### Education:

If the people of America are so opposed to the idea of government regulation of business, that they can not tolerate it to the extent indicated above, then the only alternative is to educate the people to do intelligent business. This is a good method to educate the people, make them realize the loss resulting from business failures, advise them before and after entering business to avoid failures. If all the people are educated and if they practice the principles they learned, there will be definite reduction in the number of failures. But this can not be achieved in a day or two. It will take some time to educate the people and get the best results from such education.

How to educate them will be another problem. Information on business operation should be made available to all firms. There are several sources from which information about organizing and managing a business can be secured.<sup>1</sup>

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1. Converse, P. D. "Should I Start My Own Business" p. 39.

Many books are available, which discuss organization and operation of a business, handling of labor, buying and selling goods, advertising, financing, insurance, and credits and collections. There are books on scientific management, and on the operation of retail stores, some dealing with the operation of specific types of stores, others with general problems of store layout, advertising and salesmanship. Perhaps a local library may have such books, or can furnish a list of suitable titles, with the names and addresses of the publishers. There are also a number of libraries operated by large corporations, business associations and Chambers of Commerce. They may also be helpful.

Reading the entire book of numerous pages will be a drudgery to many people. Short but clear ideas are given in pamphlet form. Magazines, bulletins and booklets are published on business practices, business conditions, merchandising and advertising. They are issued by trade associations, mercantile agencies, and Chambers of Commerce. They come out weekly, bi-monthly or monthly. One who reads them regularly and carefully with reference to current happenings of the business world will learn much about the operations of businesses in their own fields of interest.

Another source which should not be overlooked is a state university or some other large university or college

which offers courses in business. Many such schools have bureaus of business research, which publish their results of studies designed to help business men with their problems. They may also be able to furnish supplementary information or to refer inquiries to important sources. Panel meetings and discussion groups of similar tradesmen or the conference of teachers and executives of business will help to exchange ideas and discuss problems which are difficult to solve by individuals.

The Bureau of Foreign and Domestic Commerce, a subdivision of the United States Department of Commerce (Washington), provides much valuable service to present and prospective business men. This bureau has prepared many manuals designed to help persons, who wish to start various types of business and those who have already started operating businesses. It is also ready to give much additional helpful information, including the names of associations in the various trades. The Field Service office of the Bureau, located in principal cities, may be able to supply published information, direct inquirers to available data, or give personal advice and helpful suggestions.

Many banks and insurance companies give valuable advice to business men. The service bureau of the Metropolitan Life Insurance Company cooperates with many business concerns and trade associations in making available infor-



mation on accident prevention, budgetary control, better accounting methods, new products, sales outlets and many other matters. A banker may often, from experience with other business men, make suggestions that will be very worth while in financing and starting a business.

Most of the leading daily newspapers in the country pay considerable attention to the business section, and provide current information of interest. If people are tired of reading papers and writing accounts, and if they do not want to strain their eyes any more, they can listen to the radio. Radio broadcasting will be a useful means of educating the public, in the matter of business trends, business practices,<sup>and</sup> market quotations. People should be educated first to know the various sources of information and the services offered by different institutions.

It will be of interest to many, if films are taken to show the operation of a good business for the use of students and business men who are anxious to know and learn about modern business. Television has come to help us in visual aid programs.

There are many methods and sources to educate people. Reading books, bulletins, magazines and pamphlets by visiting libraries or buying them from publishers will be one method. Going to schools, taking part in discussions and business exchange meetings will be another method.

The various service bureaus of the government and private institutions are ready to offer their advice and consultation. Radio broadcasting and visual-aid programs could be increased to educate the people. If the people follow any one of the methods to suit their taste, and make use of all the available facts and facilities, the result would be steady decrease in the number of business failures. It will be of immense help for any prospective business man to receive the necessary education and training before he enters a business.

## VI. MITIGATION

So far, the discussion was centered at preventing or reducing the number of business failures. Three proposals were made -- to hold examinations, to regulate and control business, and to educate the people. Education seems to be desirable to foster the free American enterprise system. Now, the attention will be directed towards mitigating the financial losses resulting from business failures.

However much one may try to run a successful business and avoid business failures, there are always some failures due to one reason or many as mentioned before. In 1945, the total number of failures was only 810, but with a total liability of \$30,395,000. These failures are those with known loss to creditors. All failures do not result in heavy losses; because some persons quit business losing part of their capital but without any loss to creditors; and some quit while their business still shows a profit, but not a satisfactory profit as he expected.

It was found that some businesses fail due to fire, flood, etc. and result in heavy losses. Businesses as well as individuals are confronted with a variety of risks, many of which are insurable and some of which are not. The hazards confronting the business men, whether manufacturer, wholesaler, or retailer surmount in scope those of ordinary individuals. His investment in property, such as building,

fixtures, merchandise, and delivery equipment, constitutes a considerable portion of the assets of the business and must be protected against fire, flood, theft, windstorm and other similar risks. The business may be sued for damages; because a delivery truck injured a person or property; the product injured a customer; a customer or an employee was injured on the premises; or for other reasons. The business is crippled and loss is increased due to a variety of these risks. Most of these business losses can be indemnified by taking the necessary insurance policy and paying the premiums regularly.

Some of the important insurance policies for a business man are briefly explained. More details of these policies are not given in this study, because it will take time and form a separate problem by itself.

#### Fire Insurance:

The most common risk faced by every business man is fire. In spite of the best precautions which may be taken to reduce the fire hazard on one's property, a conflagration arising in adjoining land or buildings may affect the owner's property, bring the roofing of his building to the ground level, and burn it to ashes. Incendiarism and carelessness are constant sources of trouble and are responsible in setting ablaze many beautiful buildings and property in this modern electric age.



So, a standard fire insurance policy is necessary for every business man and it protects the owner of buildings, fixtures and merchandise against loss by fire. Some items like currency, securities, deeds, and notes receivables are not, generally, insured under the standard fire insurance contract. Losses or damages directly or indirectly resulting from invasion, riot, or civil commotion are also not included. But, these risks may be covered by special endorsements added to the standard fire insurance contract. The standard fire insurance contract protects the owner of the property to the extent of actual cash value of the property at the time of loss; and it will not be more than the amount it would cost to repair or replace the property with material of like kind and quality within a reasonable period of time.

#### Automobile Insurance:

Equally important as fire insurance is the automobile insurance. No country in the world, except the United States of America, has expanded her transportation facilities with automobiles of different varieties. Because of rapid rise of vehicular transportation, the risks arising from the operation of motor vehicles are increasing, and owners and operators have sought insurance protection on a large scale. There are several types of automobile insurance, and each type serves a particular purpose, and covers a particular hazard which the owner of the vehicle faces. The several types are bodily injury liability,

property damage liability, medical payment coverage, fire and theft, and collision. Most companies now write a "comprehensive fire and theft policy" which provides against bodily injury liability, property damage, fire and theft, flood, windstorm and glass breakage.

#### Robbery and Burglary Insurance:

Another hazard confronting the business man is the loss of property by burglary or robbery. There is a technical difference between these terms. Robbery is the felonious taking of personal property in the possession of another, from his person or immediate presence and against his will, accompanied by means of force or intimidation. Burglary means the taking of property by felonious entry into any house, shop, warehouse, store, mill, railroad car or vessel by force or violence when the premises are not open for business.

The insurance company writing a burglary or robbery policy reserves the right to inspect the insured's premises at reasonable times, and advises the insured to maintain a burglar alarm, a modern safe, and other devices which will prevent or reduce losses. When the property is protected by some or all of these devices, a reduction in the insurance rate is granted. There are many kinds of burglary and robbery insurance like personal hold-up insurance, safe-deposit box insurance, and paymaster robbery insurance. Besides, theft and larceny policies are written by insurance

companies to protect business men and householders against appropriation of property by employees, servants, or others having access to it.

Business Interruption Insurance:

While the fire insurance policy covers only financial loss due to the value of physical property destroyed, it does not cover the loss resulting from interruption of business or manufacture due to the same peril. If a real unforeseen loss is sustained in this way, it is a proper subject for insurance. In recent years, this has been recognized, and coverage for losses from interruption of business is offered.

When the business has been interrupted by fire, and it is impossible to occupy and use the premises, certain expenses such as bond interest, the expense of keeping a staff together, and some advertising expenses continue and must be paid. Such loss is known as "business interruption loss". It was formerly termed a "use-and-occupancy" loss, since it comes from the inability to occupy and use the premises.<sup>1</sup> The business interruption insurance enables the business man, whether he is a manufacturer, wholesaler, retailer or professional man, to pay charges which continue during the period in which the business is inoperative.

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1. Mowbray, A. H. "Insurance" p. 95.



### Life Insurance:

Many businesses operate in such a manner that certain individuals in a company are responsible for a great portion of the business transactions. Stockholders are now realizing more and more that management is one of their valuable assets. The loss of those "key men" in an organization may result in a loss of business and a decline in profits. For this reason, many corporations now buy life insurance on their top executives of high caliber and value, and in the event of their death, the proceeds of the life insurance policies compensate in some measure for the loss of business. Life insurance is also used in the liquidation of partnership interests.

### Other Forms of Business Insurance:

Goods or commodities in transit by rail, truck, plane, or ship are subject to risks. So business men can avail themselves of transit insurance, and in the event of loss and damage of goods or commodities in transit, the insurer pays the claim promptly.

There is the employee liability insurance. Accidents on the job are one of the hazards faced by employees, and the employer must insure against injury or death to his employees by subscribing to an industrial compensation fund or to an insurance plan with a stock or mutual company.

Surety and fidelity bonds can be taken by a business

man to insure against dishonesty or violation of trust by his employees.

There are several risks which can not be insured. These include shifts in business location, shifts in consumer demand, the development of new products, price changes, and changes in public opinion. By constant research and by keeping good relations with the public and the employees, an alert management will not lose much, but can take necessary precautions to reduce losses resulting from such risks. It should also be remembered that only for taking such risks, the entrepreneur is entitled for profit. However, there is another risk that could be insured, and that is the credit risk. The theory and advisability of credit insurance are considered in the following few pages.

#### Credit Insurance:

The present business failures are increasing in number and the liabilities are also increasing. The average liability per failure in <sup>1948</sup>1948 was almost five times what it was in <sup>1940</sup>1940. Current high costs and prices are attributed to be reasons for this high liability. Besides, the magnitude of credit in modern mercantile business is large. In view of the fact that business failures are inevitable, there will always be credit losses.

There are so many factors affecting business man and

his profits. But all of them are not controllable ordinarily. If the factors impairing profits are within the business organization, they can, generally, be controlled. Sometimes, however, the causes are outside the business organization and offer many difficulties. "Protection is necessary in such cases in order to maintain the profits of the business on an adequate basis, and to prevent any sudden changes in the financial status."<sup>1</sup>

#### The Principle of Risk:

In the case of life insurance, the actuaries have established, on the basis of mortality tables, that a certain percentage of men of a given age will die in the current year, that the percentage will be still larger for men a year older, larger yet for men two years older, and so on. The chance, that any particular individual will die in the current year can not be determined. But conclusions as to the group rest on the firm foundation of probability mathematics. The insurance company can establish a premium rate for the group that will yield a predictable net profit on insurance taken out by the group, despite the unpredictability of the individual members of the group. The same principle is applied in other insurance fields.

Similarly, credit analysis of a seller's individual

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1. Ackerman, S. B. & Neuner, J. J. "Credit Insurance".  
p. 2

customers can not determine which of them, over any period of time, will certainly involve the seller in bad debt losses, and which will pay, promptly or laggardly, all their obligations in full. Like insurance policy holders, credit customers fall into risk groups.

The credit rating classes established by Dun and Bradstreet, and by the special line agencies that make ratings provide a crude but workable classification of customers into risk categories. The credit worth of individuals can be known from local attorneys and bankers. The credit man must have all possible information; and he can determine good and bad risks individually for his own company by keeping record of his accounts, and possibly annual sales to them, and of the number and possibly amount of bad debt losses, and make an estimate of possible normal bad debt losses.

The over-all loss for each group may be predetermined with some degree of accuracy, though by no means with the mathematical precision possible to insurance actuaries. For each individual customer in a risk category, however, there is only a relative probability of loss that may be anticipated from his group.

#### Nature of Credit Insurance:

If the credit man makes an estimate of normal bad debt losses of his company, provision can be made for covering

them into accounting and budgetary procedure, by treating them as a special type of operating expense, or by absorbing through a bad debt reserve. Yet, the loss increases during bad times and such abnormal loss is often unforeseen, and appreciably reduces the profits. It is hard to anticipate the following events:

- A. A selling firm may have one or more large customers who form the greater portion of the selling firm's total receivables. If these one or more large customers become insolvent, it will create an abnormal loss to the seller.
- B. A good proportion of the customers may be engaged in the same kind of business, and if their business is affected by some unusual event like a technological development, a long strike or raw material shortage, then these customers may be forced to become bankrupts, and they can not pay their accounts to the seller.
- C. A substantial proportion of a firm's customers may be located in one area, which is hard hit by some unusual regional occurrence like flood, crop failure or long-continued strike in an industry. Then those customers may become insolvent, and will be unable to pay the accounts to the selling firm.
- D. A general business depression may make many small business men insolvent, and prevent them from clearing their debts to their suppliers.

An individual selling firm can not generally anticipate the above losses, and it is very difficult to make provision for absorbing such losses, without severe financial dislocation. These abnormal bad debt losses can, however, be averaged out for large aggregates of sellers with customers in all lines of business, and located in all parts of the country over a period of time. This is done by credit insurance companies.

Losses Insured:

Credit insurance covers bad debt losses resulting from the insolvency or delinquency of customers. According to the policy forms current in 1946, such insolvency is deemed to occur, when:

1. A debtor shall have absconded;
2. A sole debtor shall have died;
3. A sole debtor shall have been adjudged insane;
4. A receiver shall have been appointed for a debtor;
5. A debtor shall have transferred or sold his stock in trade in bulk;
6. A writ of attachment or execution shall have been levied on a debtor's stock in trade and said stock sold there under, or the writ returned unsatisfied.
7. A debtor shall have made a general offer of compromise to his creditors for less than his indebtedness.
8. There shall have been a recording of, or taking

possession, under a chattel mortgage given by a debtor on his stock in trade;

9. A debtor's business shall have been assigned to or taken over by a committee, appointed by a majority in number and amount of his creditors;
10. There shall have been a recording of, or taking possession under, an assignment or a deed of trust made by a debtor for the benefit of his creditors;
11. A voluntary or involuntary proceeding shall have been instituted to adjudicate a debtor bankrupt; or
12. A proceeding for the relief of a debtor shall have been instituted in a Court of Bankruptcy.

Delinquency of an account is covered, when the insured seller, under a mandatory or optional policy provision, files such account with the insurance company for collection. The indemnified shall file for collection within ninety (90) days after the account has become past due. The insurance company will take rigorous steps to collect that account. In case of insolvency, the indemnified shall file claims within twenty (20) days after acquiring knowledge of a debtor's insolvency, as defined above. The period usually covered is 12 months, and the policy is renewable after the period of expiration. This insurance will cover all of one firm's accounts under a general coverage policy; and will cover only certain specified accounts

under specific risk policy.

Premium Rates:

"The basic factor in determining premium rates for general coverage is the stipulated individual account coverage on accounts of customers in the various rating classes."<sup>1</sup> Dun and Bradstreet's rating of individuals is considered in calculating the premium rates for general coverage policies. The rate varies from \$4 for 1,000 for the best risk to \$30 for 1,000 for the poorest risk. The sum of these premiums calculated on stipulated account coverages of a policy will form the total basic premium on a general coverage policy. "No studies have been published on the costs of different kinds of credit insurance in relation to insured sales."<sup>2</sup>

Under a general coverage policy, the premium rate will be low; but it does not cover any and all bad debt losses that a seller may sustain as a result of sales made during the policy period. Only excessive losses over the normal loss from the insured accounts are covered. Years may go by without payment to the insured, or payments during that period may be less than premiums paid to the insurance company.

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1. Shultz, W. J. "Credits and Collection Management". p. 570.
  2. Ibid.



Under a specific risk policy, the premium rate is no doubt high; and therefore that policy covers fully costs on any losses sustained on the account or accounts insured.

Merits of Credit Insurance:

"The advantage of credit insurance is the prevention of undue expansion of credit, thereby avoiding unnecessary credit losses, decreasing the number of business failures, and tending to alleviate the effects of severe panics and crises."<sup>1</sup>

Credit insurance is intended primarily as protection against the exceptional bad debt losses that might otherwise be crippling.

When a single large customer suffers a business failure, and is unable to pay his debts to the seller, credit insurance gives protection to the seller against unusual bad debt loss.

When a group of customers located in a region is affected by some regional catastrophe, the seller is relieved of his abnormal bad debt losses from that group of customers.

When a group of customers belong to the same line of

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1. Ackner, S. B. and Neuner, J. J. "Credit Insurance". p. 24.

business, and their business is affected by some disaster peculiar to such line of business, then the credit insurance gives protection to the seller, and prevents him from serious bad debt loss.

When a sharp business depression arises, many customer's of a firm are affected and they are unable to pay their accounts to the seller. The primary advantage of credit insurance is realized by seller and creditors at that time.

If a delinquent insured account is turned over to the insurance company within 90 days after it becomes past due, the insurance company may be able to take more aggressive and effective action for collection than the creditor. The chances of collecting the account are greatly increased. Before submitting the customer's account to the insurance company, the creditor can send a diplomatic letter to the customer explaining the contract with the insurance company; and this letter may have some effect, and help the creditor to collect his dues. Every care should be taken in writing that letter, in order that no loss of customer goodwill results. If this letter of collection appeal proves no desired results, his account can be filed with the insurance company for aggressive collection. No matter the customer goodwill is lost now, because that customer will not then be considered a good account. This collection provision

may tend to increase the efficiency of the credit collection department of the seller.

Another incidental advantage is that this insurance makes the seller review his accounts and ratings, and spot the good risks. Hence, he will be able to sell more to good credit risks, less to bad accounts, and restrict sales to very poor risks.

Defects:

The payment of premiums on a credit insurance policy will certainly swell the business cost. The result of it will be, either the prices of the seller's goods will be enhanced, or his profits will be reduced. This is not peculiar to credit insurance. If the protection afforded against unexpected bad debt loss is worth this cost, then nobody will call it a defect of credit insurance. The same is true of all insurances like fire insurance, liability insurance where premiums are paid regularly.

The credit insurance may create the tendency in some credit departments to rely upon the insurance policy for their credit decisions, and they may not use their considered judgments. The ratings of mercantile credit agencies are a valuable guide to know the credit risk status of customers, and this forms the basis for credit insurance. This is only a guide, but not a substitute for detailed inquiry and careful analysis. If an account can be covered by insurance up to the maximum for its risk class,

a credit man may be tempted to reduce his labors by arbitrarily using such coverage as the account's credit limit. He then blindly approves all orders within the credit limit, and just as blindly refuses to check orders in excess of the limit. This may result in more bad debt losses, and the insurance company will pay less by way of compensation or charge high premium rates. The blind refusal to check orders above the policy maximum may often bring some undesirable consequences. Good business might be turned down and some good customers will not have any dealings with such a seller and finally the sales volume will go down.

It should be remembered here, that fire insurance, liability insurance or any other form of business insurance can have the effect of causing the insured enterprise to relax precautions. How many industries are there without adequate fire and safety precautions after being insured for fire and burglary? Most of the insurance companies see that the policy holder takes necessary precautions, and follow their rules to reduce the loss resulting from any risk on which they give coverage. Failure to comply with those rules will result in cancellation of their policy. Similarly, the credit insurance companies endeavor to impress upon their policy holders that their policies are no substitute for careful credit analysis and effective collection procedures. Every modern business man should

now realize the importance of credit insurance, and give his full support to such a policy.

Comprehensive Business Insurance Policy:

In view of the increasing number of business failures, and of the losses resulting from them, we have endeavored to point out the various causes of failure, and to suggest preventive methods. We proposed examination, regulation or education by which the business men could be aided in reducing the number of business failures. Finally, in order to reduce or mitigate the financial loss of failures which result from insurable risks, we have suggested various insurance policies.

The nature of risks faced by modern business is extensive and complex. Business men must purchase various types of insurance to enjoy the protection against possible failure and damages. Fire, automobile, robbery and burglary, business interruption, life insurance on executives, transit and liability insurances, surety and fidelity bonds, and finally credit insurance -- these are necessary for business men, and the number of these policies by the enterpriser will vary according to the type of business he is in. At present, credit insurance is issued to jobbers, wholesalers, manufacturers and very infrequently to retailers; and the great majority of business men continue to rely on their own credit men and on reserves to safeguard against excessive



bad debt losses, because it is felt that the premiums on credit insurance are high, and the coverage is limited and intangible.

There is a growing tendency in the business insurance field to subscribe to comprehensive policies which insure the business man against all basic risks, including credit risk. The comprehensive policy represents the most modern type of insurance in the fields of automobile and liability.<sup>1</sup> This kind of comprehensive policy should be issued to business men giving protection against all insurable business risks. The comprehensive policy for a business man arises out of the defects of the separate policy system. The defects are: (1) the insured endeavors to save money by buying only certain selected coverages, and thus is often inadequately insured; (2) rates are higher than would otherwise have been necessary because persons buy insurance only in those fields in which they are afraid that losses would be experienced -- a process of adverse selection; (3) the insureds who desire complete protection might have bought numerous policies, and still have been without assurance that all the hazards were covered; (4) it requires an expert to tell the insured what policies he needs, and inconvenience is experienced in handling them.

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1. Riegel, R. and Miller, J. S. "Insurance Principles and Practices." p. 608 & 637.

### Business Insurance Companies:

Therefore it is highly desirable to start business insurance companies, which will issue comprehensive business policies providing a broad coverage, and affording a more thorough coverage than do separate policies written on specific hazards. The government may direct the leading insurance companies to cooperate in this matter and issue a comprehensive business policy which will give full protection against insurable business risks. Such business insurance companies will require the insured to submit monthly profit and loss statements which will be carefully and confidentially scrutinized by their special auditing departments, and necessary corrections and sound advice for improvement will be made by the business insurance companies. This auditing department will also serve as a counseling center for the needy business men. There should be a business information section to give all possible information and help to business men in any matter concerning their respective lines of trade. Inquirers may be helped directly, or they may be referred to proper sources.

These business insurance companies will be run by private enterprisers, but they will be subject to state supervision. The complexity of modern economic life is increasing and the public tends to delegate to the state the investigation of those with whom it does business; the language of insurance and its processes are of a techni-



cal nature and require study and experience, if they are to be clearly understood from the insurance contracts. Abuses by private companies could be checked by state regulations and supervision. Hence, it is suggested that these business insurance companies will be under state supervision.

The state commissioners will extend their jurisdiction over business insurance companies. The rates for this comprehensive policy should be approved by the commissioners or the committee of experts appointed by the commissioner. Difficulty in making rates or problems affecting the country as a whole can be brought by state commissioners to the notice of the National Association of Insurance Commissioners, which is composed of the insurance commissioners of all states.

Compulsory versus Voluntary Comprehensive Business Insurance:

It is hoped that, if every business man is required to buy a comprehensive business insurance policy, business risks will be distributed to all business men, and premium rates will be less for adequate protection. Further the insurance companies themselves will endeavor to improve the general business standard by giving all information and advice to business men. It is worth mentioning here that the Federal Deposit Insurance Corporation has helped to prevent bank failures in the United States, and to create public goodwill toward their banks. But the membership is not

compulsory.

Many people may say that business in the United States is not too bad to force any insurance, and if the people are opposed to the idea of compulsory insurance on the plea that their freedom is being encroached upon, then the only course left open is to sell the idea of business insurance to as large a segment of business enterprisers as possible. Of course, the selling cost will increase the insurance rate, and if the freedom loving people do not mind paying that selling cost, efficient salesmanship could be used for the propagation of comprehensive business insurance policies.

If and as the practice of business insurance expands, it may be anticipated that the business insurance companies of this type in all states will become leaders in a movement to educate the people in better business principles and practices. The ultimate result will be that the American business health will tend to improve, the number of business failures will be low, and the loss resulting from any such failure will be far less damaging to the economy as a whole.

## VII. SUMMARY

This study of business failures was undertaken with the main purpose of analyzing the different causes of business failures, in order to stimulate efforts toward reduction of business failures, and toward mitigation of the financial loss resulting from such failures. The analysis of this study reveals (1) the extent of business population and failures in the United States, (2) the causes of failures -- permanent and temporary, (3) the effects of business failures, (4) proposals for prevention, and (5) suggestions to mitigate the financial loss.

The extent of business population in the United States, is expanding in every part of the country, except the District of Columbia, according to the Reports of Dun and Bradstreet, Inc., prepared in 1949. Between the years 1944 and 1949, the business population of the country has jumped by 34 per cent, the high increase being in New York and California. The failure rate in 1945 reached its lowest level since 1865 with only 4 failures per 10,000 of the total business population, largely because of the existence of a seller's market; but the liability was not the lowest in that year. Current high costs and prices involved in setting up a business and maintaining its operation are greatly responsible for the marked increase in average liabilities today. The average liability per



failure, in 1948, was almost five times what it was in 1940. The number of failures is increasing, too. It is also pointed out, that the chance of business failure during the first few years of operation is, usually, greater than after the concern has been in business for more than five years.

The opinions and ideas of different men are briefly given on the causes of business failure in different lines, and at different periods. Then, the causes are divided into permanent causes and temporary causes. Permanent causes are those causes which are ever present in business, and act as the fundamental cause to failure. Under this heading, (a) inefficient management, (b) poor accounting and high expenses, (c) ~~bad debt losses~~, and (d) insufficient capital are examined and considered to be vital causes of failure.

Temporary causes, as opposed to permanent causes, arise incidentally, stay for a temporary period, and topple enterprises, or hasten business failures. They are (a) business depression, (b) decline in value of an asset, (c) bad location, (d) business changes and improvements, (e) adverse domestic and personal factors, (f) inefficient and dishonest employees, and other causes. They have been discussed at considerable length, so that all persons interested and influential in stabilizing business, may take

appropriate action to avoid those errors in the future.

Some of the economic effects of business failures are that many creditors are unable to realize the full value of their extended credits, capital which is wasted by incapable business men, and the normal rate of interest on this wasted capital, reduce the national wealth of a country. Social effects are, that the owner loses his integrity and the community may bear the burden of supporting a bankrupt, and his employees who are thrown out of work. Further, the competitors of failed establishments may suffer losses, when the assets of failed concerns are sold at auction.

While proposing preventive measures to reduce business failures, it is said that the majority of failures can be averted, if the management was intelligent, experienced, and efficient. To check unqualified persons entering into business, examinations and the issue of dealer's license are suggested. The government can step in and extend their rules and regulations to prevent the excessive number of persons entering into the same line of business at one place. This may lead to planned economy and government regimentation which will be against the American Free Enterprise System. So, an alternative suggestion is made to educate the people by various means to do better business.

Finally, various insurance policies are taken into



account to mitigate the financial losses that affect a business man unusually to cause failure. The advisability of credit insurance is also considered at the end. Of course, the business men of today are confronted with many a hazard, and they have to purchase various types of insurance to enjoy protection against possible failure and damages.

It seems desirable to start business insurance companies with the purpose of issuing a comprehensive business insurance policy providing a broad coverage, and affording a more thorough coverage than do separate policies written on specific hazards. These companies will be under state supervision, and the rates are to be approved by the State Commissioners. They will also help the business men by giving information and advice on modern business principles and practices. By such services, it may be anticipated that these business insurance companies will become leaders in a movement to educate the people in doing better business, with the ultimate result of increasing the American business life, reducing the number of business failures, and keeping the financial loss resulting from any such failure as low as possible.



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## APPENDIX A

## Business Population for 1944 and 1949 by States

State	1944	1949	Percent of change
Alabama	21,741	36,257	/66%
Arizona	5,895	9,937	/69
Arkansas	20,102	30,067	/49
California	125,893	188,221	/49
Colorado	17,376	26,759	/42
Connecticut	31,659	40,236	/27
Delaware	4,499	5,920	/33
District of Columbia	10,612	9,117	-14
Florida	29,012	50,748	/78
Georgia	29,636	46,397	/56
Idaho	7,276	10,665	/46
Illinois	141,268	170,332	/20
Indiana	55,114	69,862	/26
Iowa	41,407	53,424	/28
Kansas	26,885	39,922	/48
Kentucky	29,670	40,680	/37
Louisiana	25,837	37,715	/46
Maine	13,556	16,764	/23
Maryland	30,879	35,438	/14
Massachusetts	75,752	89,912	/18
Michigan	75,050	100,331	/33
Minnesota	45,922	57,759	/25
Mississippi	17,274	27,780	/60

State	1944	1949	Percent of change
Missouri	60,460	78,558	/29
Montana	8,405	11,495	/35
Nebraska	22,567	29,391	/30
Nevada	2,202	3,390	/49
New Hampshire	8,661	10,649	/23
New Jersey	75,523	94,149	/24
New Mexico	6,201	11,767	/88
New York	235,343	308,041	/30
North Carolina	34,252	50,499	/47
North Dakota	9,319	11,982	/27
Ohio	102,469	132,521	/29
Oklahoma	27,898	39,774	/42
Oregon	23,184	31,566	/36
Pennsylvania	155,303	183,961	/18
Rhode Island	12,136	16,423	/35
South Carolina	16,315	25,419	/55
South Dakota	10,227	13,535	/32
Tennessee	29,482	46,149	/56
Texas	87,699	133,620	/52
Utah	7,757	11,277	/45
Vermont	6,102	7,196	/16
Virginia	29,901	43,182	/44
Washington	31,913	44,402	/39
West Virginia	20,142	27,047	/34

State	1944	1949	Percent of change
Wisconsin	59,205	72,343	<del>7</del> 22
Wyoming	<u>3,866</u>	<u>5,360</u>	<del>7</del> 38
Total	<u>1,968,847</u>	<u>2,635,939</u>	<del>7</del> 34

The above totals are the number of concerns that appeared in the Dun & Bradstreet Reference Books for January, 1944 and 1949. The listing include all types of businesses, mainly, manufacturers, wholesalers, retailers, and building contractors.

# APPENDIX, B.

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## FAILURES BY DIVISIONS OF INDUSTRY AND BY GEOGRAPHIC REGIONS - 1948

	NEW ENGLAND			MIDDLE ATLANTIC			E. N. CENTRAL			W. N. CENTRAL			SOUTH ATLANTIC			E. S. CENTRAL			W. S. CENTRAL			MOUNTAIN			PACIFIC			UNITED STATES TOTAL 1948			UNITED STATES TOTAL 1947		
	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)	No.	Liab. (000)			
MANUFACTURING																																	
Mining—Coal, Oil, Misc.	18	1056	28	2306	28	2338	11	188	1	84	4	270	2	80	1	450	5	1268	2	191	21	2581	12	674									
Food and Kindred Products	14	1046	104	4446	14	369	5	231	7	187	2	50	2	226	13	1728	10	297	51	4828	180	14264	108	19222									
Textile Mill Prods. and Apparel	33	1228	70	3700	45	1854	9	452	18	952	12	1148	9	433	3	433	3	76	68	2060	267	11903	178	14156									
Lumber and Lumber Products	6	115	24	2219	6	163	3	57	2	48	2	114	1	49	1	23	1	15	11	829	50	3531	59	9985									
Paper, Printing and Publishing	3	482	19	1707	8	287	2	99	2	40	3	49	1	7	1	7	1	25	3	386	69	2947	47	2678									
Chemicals and Allied Products	19	1050	38	1696	3	67	2	14	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—										
Leather and Leather Products	3	79	14	1759	12	270	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—										
Stone, Clay and Glass Products	13	693	28	5782	22	1576	2	88	1	84	2	200	1	36	3	535	1	75	12	1004	83	9873	76	5506									
Iron and Steel, and Products	20	3315	74	17609	59	11109	6	2316	8	1140	3	84	3	222	3	70	1	9	46	2477	220	38267	285	53155									
Machinery	2	24	10	1309	13	6235	3	88	6	179	—	—	—	—	—	—	—	—	—	—	—	—	—										
Transportation Equipment	32	7862	109	7753	53	3309	8	268	6	162	2	254	1	254	1	76	4	1413	54	4029	269	25126	289	18710									
Miscellaneous	165	16950	522	50336	265	27765	52	4280	73	4164	32	2186	37	3462	29	3263	306	17886	1481	130292	1375	26066	447	21138									
TOTAL MINING AND MANUFACTURING																																	
WHOLESALE TRADE																																	
Food and Farm Products	26	1667	39	2828	26	854	6	1434	22	679	11	868	11	293	7	230	34	1519	182	10372	102	7092											
Apparel	4	22	7	236	4	49	1	15	4	297	—	—	—	—	—	—	—	—	—	—	—	—											
Dry Goods	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—											
Lumber, Bldg. Materials, Hdwe.	4	64	14	303	8	352	2	55	1	60	5	239	6	160	—	—	8	3	183	17	480	10	668										
Chemicals and Drugs	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—											
Motor Vehicles and Auto Equip.	1	28	6	191	9	281	2	25	3	129	2	89	2	186	1	107	11	213	36	716	20	523											
Miscellaneous	32	1161	108	3498	41	1136	17	706	34	1187	6	219	18	758	10	215	58	1829	324	10709	234	8580											
TOTAL WHOLESALE TRADE																																	
RETAIL TRADE																																	
Food and Liquor	93	857	118	1233	94	1231	16	194	54	660	20	295	31	395	18	258	102	1628	546	6751	219	2799											
General Merchandise	12	125	11	236	11	364	5	33	12	186	10	157	4	36	7	90	22	293	94	1520	49	1270											
Apparel and Accessories	45	597	89	1600	40	930	8	59	40	680	8	119	11	93	2	7	70	1232	313	5317	178	2579											
Furniture, Home Furnishings	24	387	59	912	21	638	9	128	21	196	11	138	5	103	13	333	49	1046	212	3881	183	2740											
Lumber, Bldg. Materials, Hdwe.	23	356	29	491	22	420	11	155	21	366	3	68	10	174	6	65	34	739	159	2834	53	1625											
Automotive Group	15	104	28	292	29	2841	10	183	18	298	8	180	7	198	11	304	66	1386	192	5796	141	2340											
Eating and Drinking Places	70	1222	86	2223	60	718	15	173	27	392	7	79	8	166	17	390	132	4207	422	9570	226	5643											
Drug Stores	12	181	3	84	5	39	9	146	5	182	—	—	—	—	—	—	—	—	—	—	—	—											
Miscellaneous	31	332	40	583	22	249	9	93	16	198	7	95	10	308	6	70	56	1316	197	3246	145	2094											
TOTAL RETAIL TRADE																																	
CONSTRUCTION																																	
General Building Contractors	26	1266	28	2336	21	1743	2	43	14	647	2	77	6	222	2	27	64	2526	165	8887	85	4603											
Building Sub-contractors	45	598	48	979	31	396	11	226	12	237	6	179	9	124	5	75	78	2125	245	4939	145	1845											
Other Contractors	3	110	4	217	1	15	2	222	2	120	1	16	5	588	—	—	—	—	—	—	—	—											
TOTAL CONSTRUCTION																																	
COMMERCIAL SERVICE																																	
Passenger and Freight Transportation	26	676	41	85084	19	655	6	270	9	712	2	58	4	353	1	777	68	2414	176	90999	121	21857											
Miscellaneous Public Services	2	66	2	72	1	25	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—											
Hotels	6	420	3	388	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—											
Cleaning, Dyeing, Repairing	6	140	6	47	6	91	—	—	—	112	2	—	—	205	3	556	11	561	24	2130	7	3754											
Laundries	5	67	10	184	3	8	1	8	3	103	1	7	—	8	1	10	24	581	48	989	18	470											
Undertakers	2	21	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—											
Other Personal Services	4	23	9	62	6	76	2	39	2	32	—	—	—	—	—	—	—	—	—	—	—	—											
Business and Repair Services	15	215	27	460	23	790	5	51	7	150	4	34	4	131	6	129	52	1383	143	419	20	290											
TOTAL COMMERCIAL SERVICE																																	
TOTAL REGIONS																																	
	697	\$27655	1358	\$155335	773	\$41733	202	\$8555	410	\$11864	151	\$5167	201	\$8173	150	\$6992	1310	\$45092	5252	\$310566	3476	\$221048											

(LIABILITIES IN THOUSANDS OF DOLLARS)

Courtesy of DUN & BRADSTREET, INC.



## APPENDIX C

## United States Division and States

1. New England

Maine

New Hampshire

Vermont

Massachusetts

Rhode Island

Connecticut

2. Middle Atlantic

New York

New Jersey

Pennsylvania

3. East North Central

Ohio

Indiana

Illinois

Michigan

Wisconsin

4. West North Central

Minnesota

Iowa

Missouri

North Dakota

South Dakota

Nebraska

Kansas

5. South Atlantic

Delaware

Maryland

District of Columbia

Virginia

West Virginia

North Carolina

South Carolina

Georgia

Florida

6. East South Central

Kentucky

Tennessee

Alabama

Mississippi

7. West South Central

Arkansas

Louisiana

Oklahoma

Texas

8. Mountain

Montana

Idaho

Wyoming

Colorado

New Mexico

Arizona

Utah

Nevada

9. Pacific

Washington

Oregon

California

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