Small Business – Size as a Chance or Handicap

The sector of small and medium sized businesses (SMEs) is an important factor in most economies. In Germany, for instance, there are 3.2 million SMEs (1999). These are 99.3 % of all enterprises subject to VAT. These SMEs generate 44.8 % of the total turnover subject to VAT. SMEs carry out 46.0 % of gross investments; hence contribute significantly to total demand.

SMEs have a good reputation for their ability to innovate and for their close customer relationships. Smaller businesses, however, have some disadvantages that make it difficult for them to compete with the large players in their industry. This article analyses the advantages and disadvantages that result from the smaller size of an organisation.

What is small?

In order to describe the strengths and weaknesses of SMEs, it is necessary to determine, what actually a small or medium sized business is.
Literature, political and non-governmental institutions provide a wide range of definitions of the term “Small and Medium sized Enterprises” . Just the word “Small and Medium” indicates that most definitions use the companies’ size to distinguish between SMEs and larger corporations. Amongst these quantitative elements is the number of employees the most common one.
The following examples indicate the range of descriptions for the term SME.

Most quantitative definitions refer to the number of employees; some also include size limits by turnover and balance sheet total.

Definition by	**Micro Enterprise**	**Small Enterprise**	**Medium Enterprise**
	No. of employees		
US Small Business Administration	1 - 19	20 - 99	100 – 499
UK Department of Trade and Industry	1 – 9	10 – 49	50 – 249
Eurostat	1 – 9	10 – 99	100 - 499

Definition by	**Criteria**	**Small Enterprise**	**Medium Enterprise**
European Commission	No. of employees	50	250
	Turnover in Mio ECU	7.0	40.0
	Balance Sheet Total in Mio ECU	5.0	27.0
HGB	No. of employees	50	250
	Turnover in Mio €	5.4	21.7
	Balance Sheet Total in Mio €	2.7	10.7
IfM Bonn	No. of employees	1 - 9	10 - 499
	Turnover in Mio €	0.5	51.1

Figure 1 Examples of quantitative definitions of SMEs

All quantitative criteria should be used with care. It is especially important to take into consideration industry-specific differences. A car dealer with 250 employees is large, compared to the average car dealer. A car manufacturer with 250 employees, however, would be considered a small player. The criteria of balance sheet total and annual turnover might be useful for statistical reasons. Nevertheless they provide little information about the financial power of the organisation. Nevertheless, it is especially the lack of financial power that puts smaller businesses at disadvantage compared with their larger competitors. A more suitable measure would be cash flow. This, however, is even more than balance sheet total and turnover subject of individual accounting policies.

The qualitative definitions focus at special characteristics of SMEs that distinguish them from larger corporations. Similar to the quantitative definitions, a variety of qualitative definitions can be found. The element that is common in most of them is the strong linkage between enterprise and owner. Examples of quantitative definitions are:

Committee for Economic Development (US):
A small business has at least two of the following features:

- *Management is independent, since the manager usually owns the business.*
- *Capital is supplied and ownership is held by an individual or a few individuals*
- *The area of operations is primarily local, although the market isn't necessarily local.*
- *The business is small in comparison with the larger competitors in its industry.*

US Congress (Small Business Act 1953):
A small business is one that is independently owned and operated and is not dominant in its

field of operation.

(Both derived from Megginson et al,1997)

Hauser (2000) gives the following quantitative factors:

- *the identity of ownership and personal responsibility for the enterprise's activities*
- *the identity of ownership and personal liability for the entrepreneur's and the enterprise's financial situation*
- *the personal responsibility for the enterprise's success or failure and*
- *the personal relationship between employer and employees*

The definition of the European Commission (1996) also includes the element of independence. It states that an enterprise is an SME only if it is not owned by more than 25 % by a large enterprise.

In summary, the most common qualitative element in definitions for SMEs is the independent ownership, mostly by an individual, a family or a small group of individuals. Other criteria as non-dominance in its industry or relative size compared to other players in the industry can be critiqued. They ignore that many successful SMEs are highly specialised niche players, which often dominate their special niche of the market or their special industry segment. Such criteria would necessarily require defining the scope of the industry hence include more subjective elements.

Small Business or Entrepreneurial Business?

The terms small business and entrepreneurial business are sometimes used interchangeably. Although small and entrepreneurial businesses may be one and the same, the terms stand for different concepts. Megginson at al (1997) distinguish as follows.

The principal objectives for an **entrepreneurial business** are profitability and growth. The business is characterised by innovative strategic practices and/or products. The entrepreneur starts and manages a business for reasons as achievement, rapid growth, immediate and high profits and – partly – quick sell-outs.

A **small business**, which is not entrepreneurial, may never grow large. It expects normal sales, profits and growth to stay in business. The owners often prefer a more relaxed and less aggressive approach to running their business. Their principal purpose is furthering personal goals.

In the result, SMEs may or may not be entrepreneurial, whereas entrepreneurial businesses can be SMEs or large corporations. Hence, the degree of entrepreneurial sprit in an SME is largely determined by the intentions of the owners. Bridge (1980) has grouped them into three categories.

Life-style	• Often run by an individual • Facilitates and is part of the life-style the individual wants to have • Frequently found in arts or crafts, where the owner lives to practice the craft rather than practices the craft in order to live • Basis of business is more important than the level of return it can provide
Comfort Zone	• Provides the owner with sufficient level of returns for the level of comfort he wants in life • Level of benefit the business can provide in return for a reasonable amount of effort is more important than the basis of business
Growth	• Owners wish to manage the business to maximise its earning potential, especially for the future

Figure 2 Groups of SMEs according to owners' intentions

Hence, those owners that have growth intentions for their businesses are more likely to develop really entrepreneurial behaviour, which is characterised by the ability to create and sustain competitiveness through innovation.

Strengths and Weaknesses of SMEs

In order to compete successfully with larger players, many SMEs have developed characteristic competences as

- Close relationships with customers,
- Continuous innovation,
- A narrow market focus or niche strategies that allow them to specialise and excel in their fields, and
- Selected and motivated employees.

The special strengths and weaknesses of SMEs that distinguish them from larger companies are mainly determined by their typical characteristics. The most influential ones are ownership, structures and size, which all have positive and negative effects.

Due to their size and number of employees many SMEs have **simple structures and systems**. Mintzberg (1999) describes simple structures as follows: *"… it has little or no staff, a loose division of labour and a small managerial hierarchy. Little of its activity is formalised, and it makes minimal use of planning procedures or training routines. … Power tends to focus on the chief executive, who exercises a high formal profile. … The creation of strategy is, of course, the responsibility of the chief executive, the process tending to be highly intuitive."*
These simple centralised systems facilitate flexibility and shorter reaction times. They are the basis for SMEs' ability to adapt quickly to changes in their environment. However, these systems are often based on the owner's personal experience and less on objective reasons. Hence they often remain unchanged, even if circumstances would require other structures and systems. The whole strategic direction is often completely dependent from one individual or a small group of individuals over a long period of time.

SMEs are defined as **independently owned, mostly by families, individuals or small groups of individuals**. Kets de Vries (1993) states the following advantages and disadvantages of family-owned businesses. Those are relevant to other individually owned businesses as well.

Positive Aspects	**Negative Aspects**
• Long-term perspective • Dependable culture that encourages long-lasting relationships with all business partners • Strong identification/commitment, stability • Knowing the business • Family culture as a source of pride, greater resilience in hard times	• Static thinking • Managerial difficulties when family objectives and business objectives are in conflict • Less access to capital markets • Nepotism • Succession problems

Figure 3 Advantages and disadvantages of family owned businesses

The issue of nepotism indicates that the overall stable relationships small businesses develop with their partners can turn into a weakness when they favour only relatives and friends. This can make it very difficult for outsiders to come into the business, hence makes it more difficult to attract outside expertise and professional management.

The relatively **small size** of SMEs often leads to disadvantages in economies of scale. Hauser (2000) points out that this small size leads to one of the SMEs greatest strengths – their ability to offer customised and specialised goods and services. This, however, implies that many SMEs cannot make use of cost advantages in mass production. Furthermore, some types of costs are not variable in relationship with company size. Examples are devices for environmental protection (e.g. gas cleaning equipment), which are often under-utilised in smaller companies, or R&D costs. R&D as the basis for SMEs' strength in innovation and flexibility has to be undertaken on a certain minimum scale in order to lead to results. In the result of lower sales and not down-sizable costs, SMEs often incur a higher proportion of fixed costs compared to larger corporations.

The sum of issues illustrated above leads to a major problem for many SMEs: a lack of resources. This comprises financial and personnel resources.

SMEs have limited access to capital markets, due to owner-preferences and minimum requirements of capital markets. Hence they are heavily reliant on bank loans and the – often limited – financial means of their owners. In addition, Hauser (2000) notices, that although smaller companies tend to have a higher turnover yield, larger corporations are in a better position to cover temporary losses. They normally have much higher financial and non-operational incomes and a better equity capitalisation. In the result, SMEs tend to have more difficulties to finance investments or R&D projects.

Limitations in personnel resources are relevant to management and functional experts. In both areas, SMEs often lack the financial resources to hire experienced specialists. Often companies are too small to fully utilise a person solely employed for marketing or IT etc. Hence, other members of staff have to take over these functions, although they are not necessarily qualified for this. The simple, less fixed structures facilitate such cross-functional working. The result is not only a lack of experience but also a lack of capacity in manpower, especially for one-off projects. A special problem for owner-managed enterprises is to get outside management expertise into the company. Even if the owner is willing to share tasks with outsiders, such functions are often not attractive due to the dominance of the owner. In the result many companies rely solely on the owners knowledge and vision, which might be limited to his experience.

Many SMEs are very much focused on the person of the owner. The businesses' success and market position depend on the vision and the entrepreneurial talent of these persons. A well managed small or medium sized business may be able to overcome size-specific problems of resources by implementing and intelligent outsourcing strategy, by focussing on few core competencies and by developing a motivating corporate culture.

Summary

There is no doubt that SMEs face some special problems that are not an issue for larger organisations. Small size, however, is not necessary equal to disadvantages and problems. Many SMEs are much more flexible than their large counterparts, which have to meet a great variety of expectations and interests from various stakeholders when it comes to changes. Simple structures and few levels of hierarchy encourage a motivating community-like culture and a steady knowledge transfer between all members of the organisation. The stable relationships with suppliers and customers that many SMEs have developed over years, provide a degree of continuity. Small businesses can form ad hoc partnerships, cooperations and networks with other businesses in order to work on a particular project.

Moreover, SMEs are famous for their successful niche strategies. Businesses with such a strategy operate in particular market segments. Due to this specialisation the business can perfectly serve this market. However, due to the limited market volume, these segments are fairly unattractive for larger players. In the result, the small niche player does not face a significant competition.

Thus it obvious that the special characteristics of small and medium sized enterprises do not only cause problems, but also a variety of opportunities. The most important precondition for successful exploitation of these opportunities is a qualified management. It is the managements task to make the best out of the strengths in order to overcome the weaknesses.

Literature / References

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