Analysis of Factors Influencing Closure of Business: A Case of BOI Approved Companies

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ABSTRACT

Foreign Direct Investment provides benefit to developing countries like Sri Lanka, not only by supplementing domestic investment, but also in terms of employment creation, transfer of technology, and increasing domestic competition. Sri Lanka offers attractive incentives for foreign companies and has adopted a number of policies to attract foreign direct investment to the country. Board of Investment of Sri Lanka is the government organization that promotes the investments in Sri Lanka. The government annually lost average Rs. Bn 20 due to the tax concessions and facilities given to the investors. The argument is whether government can reach its targets by giving these concessions. During the past decade, there were a large number of companies closed down due to the various reasons. This study was conducted for identifying the root causes for closed down of the companies which approved under the BOI law. The research was designed to collect data from secondary data sources and primary data sources, such as interviewing and questioners. Questioners were prepared to gather data from the area of laws and policies, business environment, market, operational and company related data. This research reveals that the investment climate should be upgraded in Sri Lanka by overcoming the problems with incentive scheme, tax regulations, political stability and infrastructure facilities. The finding suggests that initiatives such as better trade policy reforms, implementation aimed at promoting foreign direct investment and domestic investment, and restoring international competitiveness to expand and diversify the country's industry sectors for better performing the economic growth in the future.

KEY WORDS: FDI, Failures, Incentives, Taxes

INTRODUCTION

Foreign Direct Investment (FDI) has been an important element of Sri Lanka's economic development process not only by supplementing domestic investment, but also in terms of employment creation, transfer of technology, increased domestic competition and other positive externalities.

The Board of Investment of Sri Lanka (BOI) was incorporated as a statutory body in 1978 as the government principle agency for the promotion and coordination of foreign and local investment in the area of industrial exports, to its present role which includes the promotion of investment in the services and infrastructure sectors as well.

It is structured to function as a central facilitation point for investors. Main target of the BOI is promoting investment opportunities to the foreign investors to attract Foreign Direct Investment.

Encourage FDI in the country; BOI introduces a comprehensive incentive scheme for the industries located in and

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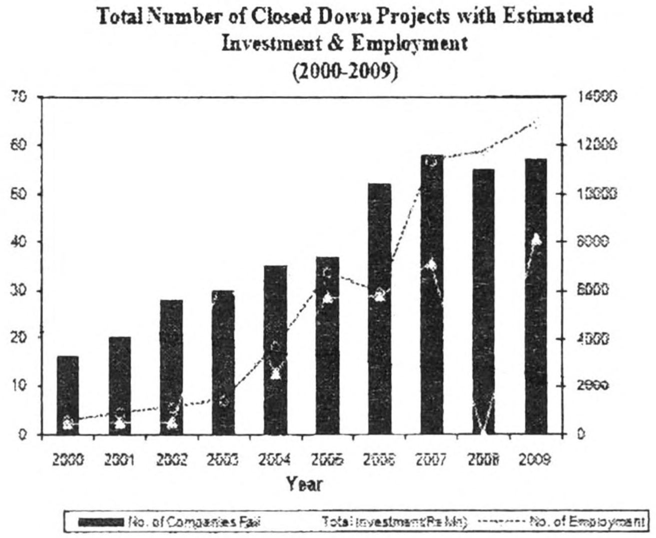
outside the zones. These incentives include lot of tax concessions including corporate tax, import and export and foreign exchange so that result high amount of revenue foregone to the country.

RESEARCH PROBLEM



Figurel: Closed Projects with Estimated Investment & Employement (BOI Management Information Syatem)

As a result of investment promotion and incentives, foreign investors have started companies. However As shown from the Figure 1 during the last decade, the failure rate of the BOI approved companies has marked rapid increase. These failures have resulted in wastage of funds; increase the rate of unemployment, loss of financial benefits and resources depriving the country from the intended benefits.

Research Objectives

The main objectives of this research were:

- To identify root causes for the closure of the companies, approved by BOI.
- To examine the possible solutions to eliminate or control causes, and reduce the rate of failure.

LITERATURE REVIEW

Business failure

Business failure, or colloquially going out of business, refers to a company ceasing its operations, reducing production, lost of market following its inability to make a profit or to bring in enough revenue to cover its expenses. The final step is always that the business runs out of cash. It has been said that running out of cash defines business failure (Rubach 2002).

Investment promotion agencies

Investment Promotion Agencies operate in a dynamic and competitive environment for attraction of FDI and the establishments of investment opportunities. Investment promotion covers a wealth of services, ranging from the provision of market information to undertake of feasibility studies and environmental impact assessments. BOI is the government agency engaged in investment promotion in Sri Lanka.

Foreign direct investment

FDI refers to long term participation by country to country (Chai and Goyal 2006). In addition to capital inflows, FDI can lead to transfers of technology and expertise, improve the access to international markets and spur competition

FDI Incentives

Measures designed to influence the size, location or industry of a FDI investment project by influencing its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors (Joel 1999). These incentives include tax holiday, exemptions from import export tariffs and exchange controls.

Factors influencing closed down business

The Global Competitiveness Report published by the World Economic Report 2009 has identified most common factors affecting for business failure:

- Tax regulations
- Tax rates
- Access to finance
- Inefficient government bureaucracy
- Inflation
- Restrictive labor regulation
- Inadequate supply of infrastructure
- Policy instability

METHODOLOGY

This research is an applied research since it was undertaken to answer specific industry problem and give solutions to it. The first step of this research was to identify common causes lead to close down. Secondly the factors influencing in the Sri Lankan context were identified. In its final step, the research presents the feasible solutions. This research utilized primary and secondary data. The primary data were collected through series of interviews done by administrating a questionnaire in the selected organizations from BOI Approved companies. The secondary source of data includes in the Management Information System of BOI. Interviews with the management were held to identify the most critical hidden reasons influenced to close down of the companies. The data collected through these interviews where used to develop the questionnaire.

The sample questionnaire has been developed including closed ended questions with five point Likert scale as well as open ended questions to gather user perception.

The questionnaire was designed specially to measure the BOI employees' attitudes regarding the business failures. Secondary data were used to identify the major issue affected to close down of the companies. The analysis of the data was performed based on the descriptive statistical methods such as mean, standard deviations, confidence intervals, pie charts, column charts.

DATA COLLECTION ANALYSIS

In order to identify main factors for closed down of Industry sectors, data about 250 closed companies were analyzed. Figure 2 indicates the frequency of reasons affected to the failure of the companies. The figure explains the 31% of closed down occurred due to laws and policy related issues. Further, 22% and 20%, responds stated that market related and operation related issues respectively. Thus, this descriptive analysis indicates (Figure 2) that the policies related issues encountered high impact to the failure of the businesses registered in Sri Lanka.

The data received from the interviews and questioners were analyzed for identifying the most critical reasons affected for laws and policy related issues. Table 1 shows the significant values of each factor which causes for laws and policy related issues.

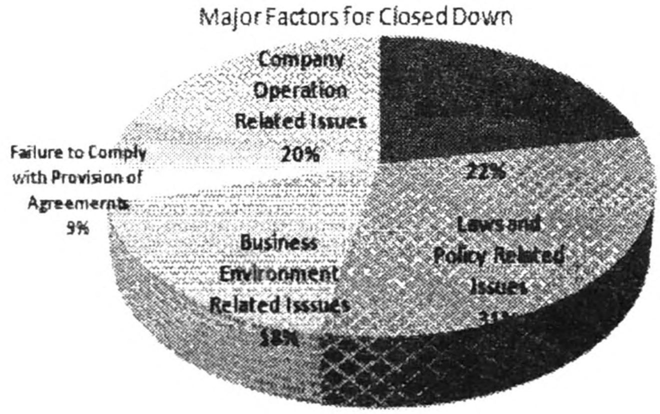


Figure 2: Percentage of factor Affecting closed Down of Business

Table 1: Causes for Laws and Policy Related Issues

Reasons	Mean	SD
Improper incentive Scheme	4.4	0.9
Various Tax Regulations	4	1
High Tax Rates	4.3	1.1
Policy Instability and inconsistency	4.1	1.3
Issues in the FTA	3.7	1.5
Direct and Indirect Barriers	3.6	1.5

Above analysis states that practically there is no specific one reason affecting the close down of the companies.

RESULTS AND DISCUSSION

The aim of this research was to study the factors influencing the failure of BOI approved companies. In according to the results obtained from the secondary data revealed that policy related issues caused to closure of the businesses. Rest of the factors, such as business environment related issues, market related issues, failure to comply with agreement and operational issues showed less influence. The analysis of Mean and Standard Deviation were used to identify the root causes for laws and policy related issues. The analyzing shows that improper incentive scheme has highest significant effect to the business failures.

There reasons such as various tax regulations, policy instability, high tax rates, issues in the FTA and import export regulations significance influence for failures.

There was significant evidence which stated that the improper incentive scheme, various tax regulations; delay across the borders affected the BOI present policies and procedures. And also it is reveal that lacks of orders, market down and high competition have significant effect. Finally, in according to the all above analysis state those cluster of reasons were affected to the business failures.

Alternative Solutions and Feasibility Study

1. Prepare pre-feasibility report of the project

It is needed to analyze market, financial profitability, raw material availability, legal conditions and human resource requirement of the project before the implementing the project.

2. Simplification of the Tax regulations

Due to the complexity of tax regulations it is needed to be simplified and tax rates should be reduced in the export oriented industries. With the simple tax regulations investors can predict their business performance.

3. Monitoring and evaluation

Through constant monitoring and evaluation a company should detect any negative symptoms like, decreasing export indicator and profit margin etc. So they can be solved sooner. This would help to reduce the probability for closing down a company.

4. Incentives should be effective to both investor and government

Incentives should be rearranged according to the benefits to the investors and country economy. After analyzing cost benefits of incentives, removing unnecessary incentives and adding beneficial incentives for investor facilitation.

Then tax incentives become effective to both country economy and investors. Considering incentive scheme, proposed to give to the investors must consider their level of value addition labor productivity, volume of exports, employment generation, productivity, infrastructure development rather than their amount of investment. It should be more specific to the industry sector business operations.

5. Focus on more profitable industry sectors

Major impediments to investments in Sri Lanka are lack of raw materials, space, credit etc. So it is needed to be turning more profit gain industries which need few amounts of resources and cost for business operations.

6. Best feasible solution

According to the proposed alternative solutions there are several feasible solutions that can be carried out because there is no one specific reason for business failures. However considering preparing a new incentive scheme is very important and it would be able to upgrade the investment climate of the country and naturally fulfills other solutions to some extent. It is operationally feasible and only need knowledge personals to analyze the trade policy.

CONCLUSION

As a developing country, the rate of the inflows of Foreign Direct Investment upgrades the whole economy. The research considered and analyzed five factors for closing down of the companies. It revealed that 31% responds encountered for laws and policy related issues. Further analysis revealed that the improper incentive scheme has highest degree level of influence to the closed down of the companies. The current incentive scheme does not cover all aspects of benefits relevant to the investors and the industries. Statistical analysis further evidences that high tax rates, various tax regulations, policy instability and inconsistency are having significance influence on the failure of the business.

The comments given in the interviews and questioners, states that there can be interdependency occurred among the factors. In general, governments should not rely on tax holidays as a principle form of corporate tax incentive and should use other, more focused instruments that may be used to more advantage for specific activities. Incentives should be tailored by priority activity and sector, as well as location to achieve more specific objectives. A sector specific approach is likely to be most effective. Tax incentives most often target large firms and multinationals. Fiscal reforms often ignore the small and medium-sized enterprises which are likely to be the most responsive to tax incentives. Policymakers need to take account of the objectives and effects of tax incentives in the designing their investment promotion strategies in order for fiscal incentives to achieve their maximum impact. The development strategy should focus on enhancing the investment climate, including by improving the regulatory environment, developing infrastructure, and raising labor productivity through skills acquisition and labor market reform. Existing concessions should be monitored and reviewed routinely, and the costs and benefits publicized of each concession granted. When tax incentives are granted for investment purposes, they should be nondiscretionary, transparent, and limited in size, duration and scope. As a result, the investment climate in the country must be improved through appropriate measures such as developing the port network, road network, railways and telecommunication facilities etc,

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