This chapter tries to identify the basic problems that prevents SMEs from breaking out. In doing so, we employ research on path dependence for a better understanding of the mechanisms that create a situation called 'lock-in' or a stage quite close to it. Path dependence (Figure 18.1) is a concept about mechanisms that make organizations stay on a certain track of development (Arthur, 1989; David, 1985; Schreyögg, Sydow, & Koch, 2009).

Figure 18.1 exhibits how organizations lose discretion in terms of available real options over time and get committed more and more. At first, an organization starts with a wide scope of possible options to choose from (phase I). The process of becoming path dependent starts with events that trigger self-reinforcing dynamics because of a number of economic and social patterns. As these dynamics get stronger, a critical juncture occurs where the operating range of an organization narrows (phase II). When this juncture is passed, the organization inevitably ends up in a lock-in situation (Schreyögg et al., 2009). In this state (phase III), decisions and commitments of the past cannot be reversed. Generally, path dependence as a phenomenon is characterized by four properties: non-predictability, non-ergodicity (run ex ante not determined), inflexibility, and potential inefficiency (Schreyögg et al., 2009).

18.2 Theoretical Foundations of Path Dependence and SME Challenges Within Crises

What are the mechanisms that cause these self-reinforcing effects in light of SMEs in crises? Path dependence suggests that four basic mechanisms play a role—namely, learning effects, adaptive expectations, coordination effects, and complementarity effects.

Learning effects point to efficiency gains by repetition (Schreyögg et al., 2009). Learning implies the generation of new knowledge and the process of embedding this knowledge in personal and/or organizational structures
so that it can be applied more easily and more powerfully. It is often based on evolving heuristics and routines for ordinary operations as well as decision-making logics in terms of management. Previously learned knowledge steers cognitive processes and can make organizations prone to inertia. Particularly in the case of dominant logics (Prahalad & Bettis, 1986), relevant knowledge undergoes selection processes with the consequence that ‘harmonic’ knowledge may pass, whereas disharmonic knowledge is rejected. It goes without saying that this may be a root cause of crises, particularly in the case of entrepreneur-centered SMEs. Hence, we propose the following:

**Proposition 1. Entrepreneur-focused dominant logics frame SMEs and reinforce downturns.**

According to Schreyögg et al. (2009), the *adaption of behavior* rests on the experiences and expectations of other persons’ reactions to the behavior. Preferences can vary in response to the expectations of others. The reason for this behavior is the human need for social belonging (Schreyögg et al., 2009). People and people-centered organizations such as SMEs are subconsciously afraid of breaking out of the mainstream and being stigmatized as ‘outsiders’ (Kulik et al., 2008), so they try to adopt industry standards the best they can. This can lead to (late) follower behavior and weaken the entrepreneurial orientation. Moreover, it makes SMEs strategically inflexible and, thus, vulnerable in case of unfortunate developments. Path research argues that these processes can be self-reinforcing (Schreyögg et al., 2009).
Moreover, in the case of negative feedback in financial terms, SMEs get disoriented and scared. Subsequently, entrepreneurs can take exaggerated defensive actions (Freiling et al., 2010).

**Proposition 2. Adaptive expectations with strategic impact dilute the strategic profile of SMEs and reinforce downturns.**

Following North (1990) and Schreyögg and Sydow (2011), coordination effects build on the benefits of rule-guided behavior. Organization-wide accepted rules and routines make behavior more stable and predictable while lowering costs. At the same time, rules and routines are deeply embedded in people’s minds and organizational structures. In case of change, they need to be unlearned and replaced by other solutions. Changes are hard, take a long time, and are uncertain in terms of outcome. Regarding SMEs in organizational crises, these coordination effects may show their downside and prevent SMEs from reorientations they sometimes urgently need. Complementarity effects build on synergies based on the interaction of two or more separate but interrelated resources, rules, or practices (Pierson, 2000; Schreyögg & Sydow, 2011). In case the of SMEs, we can often find interrelated routines, practices, and/or rules that help them gain efficiency but make organizational change hard in the same way as coordination effects do. Hence we propose the following:

**Proposition 3. Coordination and complementarity effects slow down the pace of change of SMEs and hamper renewal.**

SMEs in crises often find themselves already heading toward a lock-in in the later steps of phase 2 (Figure 18.1). Typical SME characteristics such as liabilities of smallness (i.e., resource bottlenecks) fuel the process and reduce the number of available real options more rapidly than it is common for larger entities. Insofar, the ‘tangible’ power to revitalize the company is limited and decreasing during the crisis. This leads to a shrinking execution of entrepreneurial functions (Freiling, 2008; Freiling & Lütke Schelhowe, 2014). According to Freiling’s (2008) model of entrepreneurial functions, this implies that innovation, internal coordination, arbitrage, and risk management—as four interrelated entrepreneurial functions that form the construct of entrepreneurship—are no longer executed the same way as before the crisis, which has a negative impact on performance (Freiling & Lütke Schelhowe, 2014). This causes additional inertia not considered by research on path dependence that we take into account as follows:

**Proposition 4. A lack of entrepreneurship not only triggers a crisis of SMEs but also reinforces it and has a negative impact on performance.**
18.3 Overcoming Organizational Crises of SMEs

According to the definition of Krystek (1987), a crisis needs to be understood as a situation where prime objectives of an enterprise such as compatibility, profitability, or solvency are threatened. This definition allows us to understand turnaround management as a situation where substantial decisions are required to ‘turn’ a negative or threatening situation through various actions. The development of these actions requires a managerial process and is by nature a project. The start of a turnaround situation is the recognition of the situation and the perception of the need to take action. The end of the project is the achievement of retaining stability, profitability, and the ability to meet the financial obligations of the enterprise.

Research on organizational crisis stays still more on a descriptive level rather than on an analytical and model-building one. The focus in the current chapter is to understand the process, to define factors initiating an organizational crisis, and to take appropriate measures for fixing problems, as, for example, the implementation of financial monitoring systems (Schulenburg, 2008). However, to regard turnaround as a simple matter of fixing problems will not lead to a sustainable organizational development after a crisis; it may not be of assistance at all. It takes a more substantial organizational change to retain the required strategic fit (Greve, 2010; John & Desai, 2005). Moreover, the process from the initial information indicating organizational problems up to taking managerial actions appears to be complicated, as different publications as well as the daily news of enterprise failures suggest (see, e.g., Gelshorn, Michallik, & Stähle, 1991; KFW Research, 2015). The complexity of this process contains the combination of more ‘rational’ economic arguments under the consideration of a number of psychological and behavioral challenges.

According to the clusters of research, the key issues required to break up an organizational path are as follows:

- Coping with psychological and behavioral challenges to break patterns of thinking and routines to allow change (Federowski, 2009; Freiling, 2005; Geiger & Schröder, 2014; Meyer, 2015)
- Creating financial stability in order to allow time to break up organizational patterns (Hagemeier & Welcke, 1988; Krystek & Moldenhauer, 2007; Thoma, 2010)
- Building up a turnaround governance in order to provide a structured change process and a substantial frame to determine future organizational behavior (John & Desai, 2005; Krystek, 1987; Crone & Werner, 2007)

Nevertheless, research does not provide a clear pattern of turnaround. The approach in this chapter is a structured approach to the literature as well as observations by the authors through various pieces of research and assignments in the research field (Collan et al., 2014; Freiling & Dressel, 2015; Freiling & Grossmann, 2013; Meyer, 2015).
18.3.1 Breaking the Organization Path: The Psychological and Behavioral Challenge

Change can only be performed through and with people and is not a simple technical matter of fixing problems. To prepare organizational path breaking (and finally to make it), means in the first place managing stakeholders, in particular working with the entrepreneur or small business managers. There is a need to deal with psychological effects in order to change motivation, behaviors, beliefs (trust in their), capabilities, and cluster thinking, as well as to restore the entrepreneurial motivation. The main problem is often changing routines (e.g., Geiger & Schröder, 2014; Greiner, 1972) to deal with psychological and organizational resistance. A bulk of the literature and research has been conducted to understand the pattern of a crisis (Groß, 2009; Hagemeier & Welckke, 1988; Harz, 2006; Rüsen, 2009; Börsch-Supan, Gasche, & Wilke, 2010). The main objective of this research was to develop instruments and indicators for risk management. The analysis of these patterns suggests an entrepreneurial behavior of constant organizational adjustment to upcoming strategic and operational problems (Freiling, 2005; Kehrel & Leker, 2009; Meyer, 2012; Rüsen, 2009; Crone & Werner, 2007). A false or unchanged strategic behavior extends the duration of the path, but in the end, sunken costs of resistance will determine the crisis path further (Hauschildt, Grape, & Schindler, 2006). Due to their personnel liabilities, the problems of adjustment get enhanced as they feel in charge of their company, the employees, and the product and service quality of the company.

In this context, the findings of Greve (2010) are of particular interest in order to understand a problematic organizational path as a consequence of organizational burnout. Past success made the enterprise stable and allowed for material comfort. In particular, engagement in the daily operations further fostered a lack of innovation and ideas. Once signs of an uprising crisis occur, they are answered by routines of cost cutting and price reductions. Moreover, there appears to be a desire for a ‘big bang’ in terms of the adaptation of innovation and new clients, as well as a drastic change of the economic climate without considering necessary internal measures and know-how. In order to break the path and to broaden its management, there is a need for managers to leave behind the feeling of lost chances and mutual assignment of guilt, and to return to the current organizational realities. The break in the path, however, can only be reached by defined turnaround strategies (John & Desai, 2005).

In summary, there arises a fatal triangle to be dealt with in order to allow the breaking of an organizational path (Meyer, 2015):

- Fear of losing one’s role in the company as well as receiving criticism
- Time to learn about new chances and to manage them
- Pressure to compile financial obligations as well as to avoid an organizational breakdown
Among the hopes and objectives is that managers get the old feeling back so they can control the enterprise and find some discretion.

In order to change the beliefs and values, time is required to allow a reflection of past behavior in the presence of new know-how or market perceptions. Thereby, one key for success is combining existing technical and operational knowledge with new upcoming perspectives, while at the same time unlearning things (Geiger & Schröder, 2013) that caused the organizational decline. Managers may conclude that a crisis is not a situation of their own personnel failure (Imgrund, 2009). Often one finds that they have a number of ideas for change (Meyer, 2015). These ideas were put to rest because of missing managerial support, high-risk adversity, and missing financial resources. Hence there is a need to channel this situation while introducing new market knowledge. The sparks of change, or of a returning entrepreneurial spirit, however, appear first as positive feedback that needed to be allocated to the entrepreneur in question. There is a need, according to Lewin (1947), for an ‘unfreezing’ process where outside expertise is needed to structure the problem and operationalize the necessary changes in the context of a company. Past successes of the organization need to be transferred into a new set of frames where the entrepreneur is able to maintain his or her role as manager (Meyer, 2015). In order to achieve this feeling, the following issues should be tackled in more detail:

- Decisions-making processes
- Change of managerial routines and values
- Fostering entrepreneurial motivation and resolving past conflicts

Case for Proposition 1

Entrepreneur-focused dominant logics frame SMEs and reinforce downturns.

In the south of Germany, an eco-friendly hotel operated for ten years and struggled during that time with its finances. Due to the strict application of healthy food and ecological challenges, the hotel had a sales problem. Although the clients were highly satisfied with the service, the hotel rates were quite expensive, and there were many service regulations such as no televisions in the rooms and now Internet access at night that discouraged potential customers. Market research information was only accepted by the board of the ecological hotel association or healthy food boards. In this case, it was necessary to bring customer expectations in line with the strict application of the hotel’s rules. Clients appreciate the ecological approach, but more on a practical hybrid basis.

In the implementation of the compromise and its marketing, it was observed that the number of reservations rose quickly. Moreover, due to a conflict between the partners of the hotel, the owners decided to separate. This action reduced a number of resistances and sped up the decision-making process. Today, the hotel has good profits and stands as a model for a good eco-friendly hotel.
According to Lange (2004), the most predominant issue is altering the decision-making process. Due to the perceived market and customer knowledge, there is a tendency to neglect external information. One can observe that complex or new information is neglected because it is not understood. Furthermore, the consequences of innovation and market trends can be misinterpreted. The validity or representativeness of information is often not questioned and single instances are generalized (John & Desai, 2005). The application of the information is often guided by the feeling (and the approach) of preserving their own status. Decisions are often guided more by trust than an evaluation of the cost/benefits or profit/loss (Meyer, 2015). In particular, an evaluation of existing services or products takes place in the context of existing customers and not through a value-free benchmarking approach.

Federowski (2009) stresses in this context the impact of managerial routines on breaking up organizational paths. Inadequate managerial routines foster the occurrence of organizational crises, including how market and cost information is interpreted, how processes in the organization are managed, and how decision-making processes are performed. The logic of thinking, selection, and interpretation of information can inhibit turnaround processes. For a successful breaking of organizational paths, these routines must either be altered or unlearned and replaced by the introduction of new routines while broadening the organization’s way of thinking. As an example, competition is answered by a cost and price reduction rather than by an evaluation of the company’s own market position, customer value, and product or service price (Greve, 2010). The know-how transfer is the provision and application of analytical tools and includes fostering the use of new technology. The climate of this knowledge transfer must be designed by a peer relationship between the external expert and the entrepreneur in question (John & Desai, 2005).

Case for Preposition 2

Adaptive expectations with strategic impact dilute the strategic profile of SMEs and reinforce downturns.

Gochon the butcher provides various meat and butcher products in a rural region. Furthermore, he offers a catering service to a neighborhood chemical plant. Due to the well-established services in the past, good profits have been realized and special capacities have been built up for this service. After a decline within the chemical industry, the requests for catering decreased as well as the prices that were more or less ‘dictated’ by the chemical plant. The effect was the service lost its profitability. However, the butcher needed to maintain business for the enterprise. Although the financial figures presented a clear language, the business was regarded as a sign of stability and security. Moreover, the butcher felt very much at ‘peace in the neighborhood.’ Hence
the owner stuck to providing the services to the chemical plant although the request for regional meat products increased. Only after a clear strategy with the objective to separate the enterprise from the business did he find the energy and solid ground to negotiate new prices. The turnaround strategy involved separating the enterprise from the catering service to the chemical plant and concentrating on the traditional service of butchery. Once this separation was performed, the organization returned to profitability, and the owner is now investing in the production of regional meat products.

To empower the entrepreneur to change routines, he must have the feeling of losing the tight of financial distress. This feeling is regarded as a first success and fertilizes the readiness to open up to change and to return back to the role of entrepreneur. This will also allow for a change of routines and to cope with organizational resistance by applying a structured approach. In order to conduct major changes, clear project management is required to give the organization some stability to rely on (Faulhaber & Grabow, 2009).

The other challenge is that management, as well as the staff, must be committed to the change process and being involved in it. This is not a one-off exercise and requires constant communication. In family and smaller businesses, there is a need to define the new roles and to provide the knowledge to reduce conflicts. Of major importance is that the company treats a member who is altering or losing power with utmost care to reduce organizational resistance. This period of change is a coaching exercise to help staff learn to maintain a commitment to change (John & Desai, 2005).

The need to transfer the required know-how needs to be financed by a low-threshold approach (e.g., consultancy support by public grants) (Meyer & Paulsen, 2016). Often one finds that once managers have gotten the feeling of retaining the situation, a firework of ideas begins that was hidden in the past. There was always a fear and sometimes resignation of taking the actions for change. Once the ice is broken, turnaround happens by itself when it encounters a renewed entrepreneurial drive. The value of this know-how transfer is appraised differently at a later time, and one is prepared to pay for it for future assignments.

Case for Preposition 3

Coordination and complementarity effects slow down the pace of change of SMEs and hamper renewal.

Neptun, a third-generation family restaurant, offered banquets, catering, and restaurant services, as well as forty-six hotel rooms at a three-star level. In the past, the style of that restaurant was very successful, and the company
grew to be a leading enterprise in the region. Then development stopped and declined during the last five years.

The style of the restaurant and the pricing policy, as well as the service strategy, led to the company’s decline and staff turnover. As a result, the cost of production and, in particular, the cost for labor was very high. The enterprise did not make a profit. Due to the pressure from the bank, an external consultant was engaged to increase profitability. Despite all of the figures, the owners defended their processes with the argument that clients were satisfied with their services. In very small steps, and with a huge amount of resistance, the owners opened up to the alteration of processes, including personnel planning. Moreover, the communication between different departments improved. As a result, the cost of labor decreased incrementally, and the company returned to a profitable situation. Since the financial burden eased, the climate in the organization changed, and the enterprise became ready for succession. New marketing activities and the use of e-commerce for hotel reservations allowed for further change of the organization path.

18.3.2 Breaking Organization Path: The Financial Challenge

The management of finances is another starting point for any turnaround situation. It prepares the organization for breaking the existing organizational paths (Hagemeier & Welkcke, 1988; Crone & Werner, 2007). This need is due to the legal implications of the insolvency law and may hamper reconstruction because of a strict definition of solvency. In case of an off-court reconstruction, a positive going-concern prognosis is required to achieve the cooperation of the trustees who request a restructuring plan (Thoma, 2010).

Financial restructuring is often a matter of demonstrating financial management and the consequence of actions rather than the money (Meyer, 2015). The underlying problem is maintaining stakeholders’ trust, which can only happen with solid business planning and action. In particular, trustees like to see that measures to change the situation are in place. In the long run, this approach may lead to a change in the trustees’ attitudes and often to financing for new ventures.

Case for Preposition 4

A lack of entrepreneurship not only triggers a crisis in SMEs but also reinforces it and has a negative impact on performance.

The carpenter James Oak was a successful business starter and offered individual furniture craft services to households and enterprises. Due to a fast-growing business, he started increasing his workforce without considering the required additional turnover to finance the extra costs. As a consequence,
he operated with losses and worked without paying himself a salary. After a while, he lost the entrepreneurial motivation to seek new orders, and the enterprise faced significant financial problems. Strict financial and revenue planning turned the situation around. In addition, through the help of an external consultant, the owner became aware of the significance of economic relationships and performance measures for future decision making. As a result, he regained his entrepreneurial motivation while fulfilling the forecasts and returned to the required creativity in his business. Now the enterprise has grown, and James is investing a substantial amount to enlarge production capacities.

The first step in meeting the financial challenge is to know all parties and creditors involved in a turnaround situation (Buth & Hermanns, 2014; Faulhaber & Grabow, 2009; Meyer, 2012). It is a stock-taking exercise, including identifying the stakeholders’ motivation for collaboration. With the objective to change and to broaden the organizational path, successful financial restructuring means retaining solvency as well as using the internal cash flow for small investment in the area of product development or marketing activities. Once the trustees have a feeling of true communication, they are likely to cooperate and agree to a moratorium. Thereby both sides need to come to the conclusions that they are only winning parties once they start to collaborate (Slatter, Lovett, & Barlow, 2006). The initial step needs to be done by the organization in question to create transparency. This is a major challenge for entrepreneurs. Due to the ownership, first-time successes will lead to an increase in the pace of change, thanks to the organizational advantages of smaller companies. However, there is also the danger that once these problems have been resolved, smaller businesses will become reluctant to pursue further necessary changes, although the owners have noticed the need for those changes.

Financial restructuring efforts need to pursue a twofold strategy to deal with the risk adversity of commercial banks and other creditors (Buth & Hermanns, 2014). In the first place, it requires solid forecast and revenue management, including benchmarking to identify problem areas. Sometimes this means turning over every stone within an organization to seek out improvements. It is an incremental process and not a one-time exercise to build up trust and solvency. In the quest to achieve financial stability and to regain control of the situation, external possibilities of funding are limited for smaller companies (Meyer, 2015). In most cases, there are only internal measures possible (e.g., to increase the cash flow, to retain the capital serving capacity):

- Cost cutting while revising existing contracts and processes
- Revising the pricing policy and calculation
- Revising accounting procedures and the appraisal of assets
- Revising stock taking
- Revising invoicing and creditor procedures
The application of these measures requires a lot of creativity as well as resolute actions by the turnaround team. Only in later stages will the smaller companies have access to new funding for long-term changes. The desire for additional funding for changes and outstanding debts in a one-off approach is often not feasible. The bank has to find reasons for funding in the rating procedures. Creativity and entrepreneurial spirit are often needed to finance the necessary initial changes (Faulhaber & Grabow, 2009; Harz, 2006). Once these changes take place and the bank is able to see an increase in profitability and competitiveness, it will be more willing to provide new financial capital. Once this moment is realized, managers can return to their entrepreneurial spirit and break with organizational paths as the research on failure and restart suggests. Cooperation and communication with trustees is crucial during the crisis and needs to be learned. This also includes the performance of financial monitoring systems to support the professional approach and to retain trust.

18.3.3 Turnaround Governance

Turnaround governance is a clear approach to conducting the turnaround project. Managerial instruments are used in such a way that declining situations can be turned based on valid information (Hagemeier & Wlecke, 1988). The problem with governing a restructuring effort is that, often due to financial pressure, the aforementioned challenges need to take place simultaneously (Groß, 1988). Only by using a clear approach based on the model in Figure 18.2 can the requirements for governance be achieved while

![Figure 18.2 Turnaround Governance](image-url)
maintaining the entrepreneur on board (Harz, 2006; Schellenberg, 2007; Crone & Werner, 2007).

In the development of a reorganization plan, strategic reorganization plays a decisive role in the process. In particular, the following questions should be answered:

1. What is the future marketplace of the company?
2. Why do we need the company?

Once these questions have been answered meaningfully, the turnaround team is able to balance the organizational activities with the needs of the environment, and they may be to break paths in light of newly defined chances. After developing a turnaround strategy, the operative reorganization plan can be deduced from the strategy as well as the planned cash flow for financial commitments. These tasks require a solid knowledge of the turnaround situation and the willingness to take decisions and action. Moreover, in respect to small family businesses, managerial conflicts and power struggles need to be channeled to create a constructive environment for organizational change (Meyer, 2015).

In the implementation phase, the first step could be to install financial and managerial monitoring systems as a renewed approach to cooperative governance. With this action, knowledge transfer begins, and managers start to alter their decision-making processes based on rational arguments. In the case of smaller companies in a turnaround situation, managers start a benchmarking approach and identify their choices for changing organizational paths. In addition to fostering creativity and motivation to break with a path, there is a need to simplify organizational procedures and decisions and to bring in the knowledge to set up the procedures according to the resources of the company. This approach allows managers to consider their own strategic advantages and not to ‘die in beauty.’ Organizational change is not only the approach to move boxes; organizational changes must be market driven to allow a change of mentality and visions within the organization. This includes preparing its members for future tasks by using a hands-on approach.

With the objective to provide governance for a sustainable development of the enterprise, the following areas should be recognized:

- Articles of association or succession arrangements: This deals with the interest to influence the decision-making process as well as the obligations of each organizational member.
- Accounting procedures and financial reporting standards: There are often possibilities to value the equity of enterprise in such a way that the current rating can be improved.
- Installment of a management board or coaching possibilities: To break constantly with routines and to improve the quality of decision making.
• Reorganization of the duties of the manager: To allow more time to reflect a current situation and foster constant change.
• Arrangement of regularly management reviews: To maintain the range of organizational choices.

There is a need to set up constant path monitoring by a managerial monitoring system. Once the behavior as been established, the likelihood of perceiving and converting organizational choices increases (Schreyögg, 2013).

18.4 Conclusions

Besides all legal and financial requirements and burdens, turnaround management to break organizational paths is a matter of communication and personnel interaction. The driving force is the entrepreneur who needs to be ready to accept change, accept outside expertise, and promote the process. Turnaround is a matter of trust, presenting objective and purpose-oriented actions rather than waiting for a big bank. It is not an easy task or a one-off exercise. It is a period of constant interaction and development.

Change cannot be initiated by ‘rational’ models introducing input/output relationships for the measurement of profitability based on rational decision making. Change, also in turnaround situations, is more of a political- and emotional-based issue, as small business managers fear their role as managers and they tend to defend their routines and positions. Thus the emotional approach needs to be considered in such a way that empathies model through communication and emotional binding creates a situation of harmony. Moreover, it serves the purpose to recognize fear and feelings. Symbols seem to have great value here (Schellenberg, 2007). In summary, key points for successfully breaking organizational paths are as follows:

• Resolve conflicts within management or family boards
• Implement financial monitoring instruments
• Introduce knowledge for the generation of innovations
• Explore a market-based view
• Restore financial solvency in order to retain a liable business partner
• Coach changes and provide a helping hand
• Cope with pressure

Based on the belief that managers are able to learn entrepreneurship, at least to some extent, one can conclude that once managers reach a dead end and then return, they are more prepared for organizational development. In particular, the resistance to breaking up with organizational paths can be reduced. There is a need for further research to look at the psychological side of turnarounds in order to understand the triggers of entrepreneurial action and behavior in a crisis situation. Existing research suggests that we are at
a starting point but do not yet have a model of these triggers (Dobusch & Kapeller, 2013).

References


