CHAPTER 3

BUSINESS FORMATION

3.1 INTRODUCTION

- A business formation deals with the **formalization** and **actual implementation** of business **ideas** in to **practice.**

- In today's economic development/ transformation, **small businesses are creating new jobs even as large businesses continue eliminating jobs** and they are **more flexible than large ones in the products and services they offer.**

3.2 The Concept of Small Business Development

- Specifying size and **standard to define small business** is necessarily arbitrary, because people adopt **different standards** for different purposes.
- Based on socio- economic conditions, **countries define small business differently.**
- But **all may use size and economic criteria** as a base to define small business.

- **Size criteria include number of employees and the startup capital.**

- Small and medium enterprises (SMEs) cover a wider spectrum of industries and play an important role **in both developed and developing economies.**

- Ethiopia is no exception and SMEs occupy a **prominent position in the**

3.3 Forms of Business (A Short Explanation)

- There are **three basic legal forms** of business formation with some variations available depending on the entrepreneurs' needs.
- The three basic legal forms are:-

  1. Proprietorship,

  2. Partnership, and

  3. Corporation, with variations particularly in partnerships and corporations

- **Proprietorship-** Form of business with **single owner who has unlimited liability**, controls all decisions, and receives all profits.

- **Partnership- Two or more individuals having unlimited liability** who have pooled resources to own a business.

- **Corporation- Separate legal entity** that is run by stockholders having limited liability

- These three basic legal forms are compared with regard to ***ownership, liability, start-up costs, continuity, transferability of interest, capital requirements, management control, distribution of profits, and attractiveness for raising capital.***

3.4 Definition and Role/Importance of SMEs in Developing Countries

3.4.1 Definition of SMEs

- Small businesses are **playing an important role in the industrial economy** of the world.
- These are **particularly important in the developing economies**.
- Small business is **predominant** even in **developed** countries such as **USA**, **Japan** etc.

- There is a difference between **small business owners** and **entrepreneurial ventures** as well.
- An entrepreneurial venture often is a **growth-oriented innovative company** with product or service **offerings that are new to the market.**
- Small businesses could be entrepreneurial ventures.
- Most entrepreneurial ventures start as a small business.

- **Most small business owners** work with known products and services **aimed at incremental growth,** and their innovation is **focused on sales**, **marketing**, and **market expansion.**

- Entrepreneurial ventures incorporate a different set of strategies.

- These entities are aimed at **rapid growth** and apply **innovation and creativity** at every node of the business process.

- They work with new offerings, and they face a lot more uncertainties.
- There are two approaches to define small business.
- They are: **Size Criteria**, and **Economic/ control criteria**.

1. Size Criteria- Even the criteria used to measure the size of businesses vary; **size refers to the scale of operation.**

- Some criteria are applicable to all industrial areas, while others are relevant only to certain types of business.

- For instance, some of the criteria used to measure size are: **number of employees**; volume, and value of **sales turnover**, **asset size,** and **volume of deposits**, **total capital investment**, **volume/value of production**, and a combination of the stated factors.

- The following general criteria for defining a small business are suggested by Small Business

- **Financing** of the business is **supplied by one individual** or a **small group**. Only in a rare case would the business have more than **15 or 20 owners**.
- Except for its marketing function, the firm's **operations** are **geographically localized**.
- Compared to the biggest firms in the industry, the business is small.
- The number of **employees** in the business is usually **fewer than 100.**

- This **size criteria** based definition of SMEs **varies from country to country.**
- **All over the world**, **number of employees** or **capital investment** or **both** has been used as the **basis for defining** SMEs.

2. Economic/Control Criteria

- **Size does not always reflect** the true nature of an enterprise. In addition, **qualitative characteristics** may be used to differentiate small business from other business. The economic/control definition covers:

- Market Share,
- Independence,
- Personalized Management,
- Technology, and
- Geographical Area of Operation.

3.4.2 Role/Importance of MSEs in Developing Countries

- Small and medium enterprises (SMEs) cover a **wider spectrum of industries** and play an **important role in both developed and developing economies**.

- Ethiopia is no exception and SMEs occupy a **prominent position** in the development of the Ethiopian economy.

- Over the years, the number of SMEs is **growing from time to time** and they **need a strong support** on Scio-economic and political ground. **Some of the contributions are hereunder.**

1.Large Employment Opportunities: MSEs are generally **labor-intensive.**

2.Economical Use of Capital: MSEs need relatively **small amount of capital**. Hence it is **suitable to a country like Ethiopia** where capital is

3.Balanced Regional Development/ Removing Regional Imbalance: Generally small enterprises are located **in village and small towns.** Therefore it is possible to have a **balanced regional growth** of industries. Ethiopia is a land of villages.

4.Equitable Distribution of Wealth and Decentralization of Economic Power: It **removes the drawbacks of capitalism**, abnormal profiteering, concentration of wealth and economic

5.Unregulated Growth of Large-scale industries results in concentration of economic power in the hands of a few; and consequently, gross inequalities in the distribution of income and wealth will occur.

- On the other hand; **income generated in a large number of small enterprises is dispersed more widely** and its benefit is derived by the large segments of the society.

6.Dispersal over Wide Areas- SMEs has a tendency to disperse over wider areas and they play a **key role in the industrialization** of a developing country.

7.Higher Standard of Living: MSEs bring **higher national income**, **higher purchasing power** of people in rural and semi-urban areas.

8.Mobilization of Locals Resources/ Symbols of National Identity: The spreading of industries even in small towns and villages would encourage the habit of thrift and **investment among the people of rural areas.**

3.5 Setting up Small Scale Business

- Once an individual decides to take up entrepreneurship as a career path, to be a job provider instead of a job seeker, s/he has to establish an enterprise.

- The **entrepreneurial process** of launching a new venture can be divided into three key stages of: **Discovery; Evaluation;** and

- **Discovery:** The first stage of discovery is to **identify opportunities** that may form the basis of an entrepreneurial venture.

- **Evaluation:** By the end of first stage of discovery, you should have selected an **idea worthy of further detailed investigation.**

- **Exploitation:** By the end of the second stage of evaluation, you should have identified an opportunity that has **reasonable prospects of success**, and analyzed what is required to launch it.

- **Environmental Analysis:** Entrepreneurship does not exist in a vacuum. It is affected by and affects the environment.

3.6 Small Business Failure and Success Factors

3.6.1 Small Business Failure Factors

- **Causes of Business Failure**
- The **rates of business failure vary** greatly **by industry** and are affected by factors such as **type of ownership**, **size of the business**, and **expertise of the owner**.

- The **causes** of business failure are **many** and complex; however, the most common causes are **inadequate management** and **financing**.

- **Business Termination versus Failure**
- There is a **difference** between a business **termination** and a **business failure**.
- A **termination** occurs when **a business no longer exists for any reason.**
- A **failure occurs** when **a business**

- **3.6.2 Small Business Success Factors**

1.Conducive Environment- *Political, economic, technological and socio-cultural factors* in the environment impinge upon the life of the small enterprises and generate much of the needs required for their existence.

2.Adequate Credit Assistance- Adequate and timely supply of credit is critical for new entrepreneurs to emerge especially from a wide base.

3.Markets and Marketing Support- The small business entrepreneur will be in **competition** not only **with locally mass-produced goods** but **even imports.**

3.7 Classification of Enterprises in Ethiopian Context

- **I. In Case of Manufacturing Enterprise (Manufacturing, Construction and Mining):**

- ***a) A Micro Enterprise*** is one in which the investment in plant and machinery (total asset) does not exceed **birr 100,000** (one hundred thousand); and operates with **5 people** including the owner.

- ***b) Small Enterprises*** is one in which the investment in plant and machinery (a paid up capital of total asset) of **birr 100,000** (one hundred thousand) and **not more than Birr 1.5 million**; and operates with **6-30 persons**.

II. In Case of Service Enterprise (Retailing, Transport, Hotel and Tourism, ICT and Maintenance):

a) A micro enterprise is one with the values of total asset is **not exceeding** Birr **50,000**(fifty thousands); and operates **with 5 persons** including the owner of the enterprise.

b) Small Enterprise is one in which the total asset value or a paid up capital of birr 100,000 (one hundred thousand) and **not more than Birr 1.5 million**; and operates with **6-30 persons**.

Priority Sectors and Sub-Sectors for MSEs Engagement In Ethiopia

- ***1.Manufacturing* Sector-** This is the one which comprises textile and garment; leather and leather products; food processing and beverage; metal works and engineering wood works including furniture and ornaments service; and agro-processing.
- **2.Construction Sectors-** This is the one which comprises sub-contracting; building materials; traditional mining works; cobble stone; infrastructure sub-contract; and prestigious goods

- **3.Trade Sectors-** This is the one which comprises whole sale of domestic products; retail sale of domestic products and raw materials supply.
- **4.Service Sectors-** This is the one which comprises small and rural transport service; café and restaurants; store service; tourism service; canning/packing service; management service; municipality service; project engineering service; product design & development service; maintenance service; beauty salon; and electronics software development; decoration and internet café.

- **5.Agriculture Sector (Urban Agriculture)** - This is the one which comprises modern livestock raring; bee production; poultry; modern forest development; vegetables and fruits; modern irrigation; and animal food processing.

3.8 Main Supporting Packages for MSEs Development in Ethiopia

- When entrepreneurs decide to involve and develop MSEs in Ethiopia, they are more likely entitled with **some supporting packages** which include awareness creation about the sector; provision of legal services, to form legal business enterprises; providing technical and business management training; financial support based on personal saving, 20/80 (the beneficiaries save 20% and the MFIs provide loan of 80% for the projects); facilitate working premises; industry extension services and BDS provision; bookkeeping and audit services.

3.9 Problems of Small Scale Business in Ethiopia

- **Small-scale businesses** have not been able to contribute substantially to the economic development, particularly **because of financial, production, and marketing problems.**
- These problems are still **major handicaps** to their **development.**
- **Lack of adequate finance and credit** has always been a **major problem** of the Ethiopian small

- **Small-scale units do not have easy access to the capital** because they are mostly **organized** on **proprietary** and **partnership** basis and are of **very small size.**

- They do not have easy access to **industrial sources of finance** partly **because of their size** and partly because of the fact that their surpluses which can be utilized to **repay loans are relatively small.**

- Because of their size and partly because of the limited profit, they search for funds for investment purposes.

- Consequently, they approach traditional money lenders who **charge extra high rate of interest** hence small enterprise continue to be **financially weak.**

- Small scale enterprises find it **difficult to get raw materials of good quality** at **reasonable prices** in the field of production.

- Furthermore, the **techniques of production**, which the enterprises have adopted, are usually outdated.

- Because of their **poor financial position** they are **not able to buy new equipment**, consequently their productivity suffers.

3.10 Organizational Structure and Entrepreneurial Team Formation

- **3.10.1 Introduction**
- Significant to potential investors is the **management team** and its **ability** and **commitment to the new venture**.
- Investors will usually demand that the management team **not attempt** to operate the business as a **sideline** or **part-time venture** while employed full time elsewhere.

- It is unacceptable for the entrepreneurs to try to draw a large salary out of the new venture, and investors may perceive any attempt to do so as a **lack of psychological commitment to the business.**
- **3.10.2 Designing the Organization**
- The entrepreneur may find that he or she **performs all the functions** of the **organization alone**.
- This is a common problem and a significant reason for many failures.

- The entrepreneur sometimes thinks that he or she can do everything and is **unwilling to give up responsibility** to others or even include others in the management team.

- Regardless of whether one or more individuals are involved in the start-up, as the workload increases, the organizational structure **will need to expand to include additional employees** with defined roles in the

- **3.10.3 Building the Management Team and a Successful Organization Culture**

- In conjunction with the design of the organization, the entrepreneur will need to **assemble the right mix of people** to assume the responsibilities outlined in the organization structure.

- In essence, the **team must** be able to **accomplish three functions**:-

  -Execute the business plan;

  -Identify fundamental changes in the business as they occur; and

  -Make adjustments to the plan based on changes in the environment and market that will maintain profitability.