CHAPTER THREE

BUSINESS FORMATION

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

- **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:** Include number of employees and startup capital and doesn’t always reflect the true nature of an enterprise as qualitative characteristics also used to differentiate small business from other business.
- The economic/control covers market share, independence and personalized management.

Con't...

- Micro and small enterprises (MSEs) play an important role in both developed and developing economies.
- Ethiopia is no exception and MSEs could occupy a prominent position in the development of the Ethiopian economy.
- *Less capital, enjoy quick returns and have the flexibility to handle the vagaries (change) of the market.*
- , they have to face *many problems like lack of finance, poor operations management, lack of experience, poor financial management*, etc,.

There are three basic legal forms of businesses.

- Proprietorship
- Partnership and
- Corporation

Description of Legal Forms of Business

- The legal forms are classified based on
  - Ownership
  - Liability
  - Start-up costs
  - Continuity
  - Transferability of interest
  - Capital requirements
  - Management control
  - Distribution of profits or losses
  - Attractiveness for raising capital.

Table 3.1 Factors in Three Forms of Business Formation

Factors	Basic Forms of Business Formation		
	Proprietorship	Partnership	Corporation
Ownership	• Individual	• No limitation on number of partners.	• No limitation on number of stockholders.
Liability of Owners	• Individual liable for business liabilities.	• In general partnership, all individuals liable for business liabilities. • Limited partners are liable for amount of capital contribution. • In limited liability partnership (LLP), there is no liability except when negligence exists.	• Amount of capital contribution is limit of shareholder liability.
Costs of Starting Business	• None, other than filing fees for trade name.	• Partnership agreement, legal costs, and minor filing fees for trade name.	• Created only by statute. • Articles of incorporation, filing fees, taxes, and fees for states in which corporation registers to do business.
Continuity of Business	• Death dissolves the business.	• Death or withdrawal of one partner terminates partnership unless partnership agreement stipulates otherwise. • Death or withdrawal of one of limited partners has no effect on continuity.	• Greatest form of continuity. • Death or withdrawal of owner(s) will not affect legal existence of business.
Transferability of Interest	• Complete freedom to sell or transfer any part of business.	• General partner can transfer his/her interest only with consent of all other general partners. • Limited partner can sell interest without consent of general partners. No transfer of interest in an LLP.	• Most flexible. Stockholders can sell or buy stock at will. Some stock transfers may be restricted by agreement.
Capital Requirements	• Capital rose only by loan or increased contribution by proprietor.	• Loans or new contributions by partners require a change in partnership agreement. • In LLP partnership, entity raises money.	• New capital raised by sale of stock or bonds or by borrowing (debt) in name of corporation.

Management Control	• Proprietor makes all decisions and can act immediately.	• All general partners have equal control, and majority rules. • Limited partners have limited control. • Can vary in an LLP.	• Majority stockholder(s) have most control from legal point of view. • Day-to-day control in hands of management, who may or may not be major stockholders.
Distribution of Profits and Losses	• Proprietor responsible and receives all profits and losses.	• Depends on partnership agreement and investment by partners.	• Shareholders can share in profits by receipt of dividends.
Attractiveness for Raising Capital	• Depends on capability of proprietor and success of business.	• Depends on capability of partners and success of business.	• With limited liability for owners, more attractive as an investment opportunity.

3.4 Definition and Role/Importance of SMEs in Developing Countries

3.4.1 Definition of MSEs

1. Size Criteria approaches

- Though the criteria used to measure the size (scale of operation) of businesses vary.
- The most widely used yardsticks are;
  - The 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

Con’t...

- The general criteria are suggested by Small Business Administration (SBA).
  - Owne*d and financed by one individual* or a *small group*/ 15 or 20 owners in a rare case/.
  - The firm’s operations are *geographically localized*.
  - The *business is small* Compared to the biggest firms in the industry
  - The number of employees in the business is usually *fewer than 100.*

2. Economic/control criteria approach.

Covers four characteristics :

- *Small market share:* it is not large enough and unable to influence the prices of national quantities of goods sold to any significant extent.
- *Independence:* ,the owner control the business himself/herself.
- *Personalized Management:* little delegation/ the owner actively participates in all aspects of the management of the business
- *Limited geographical area of operation;* The operation of a small firm is often local.

3.4.2 Role/Importance of MSEs in Developing Countries (Reading Assignment)

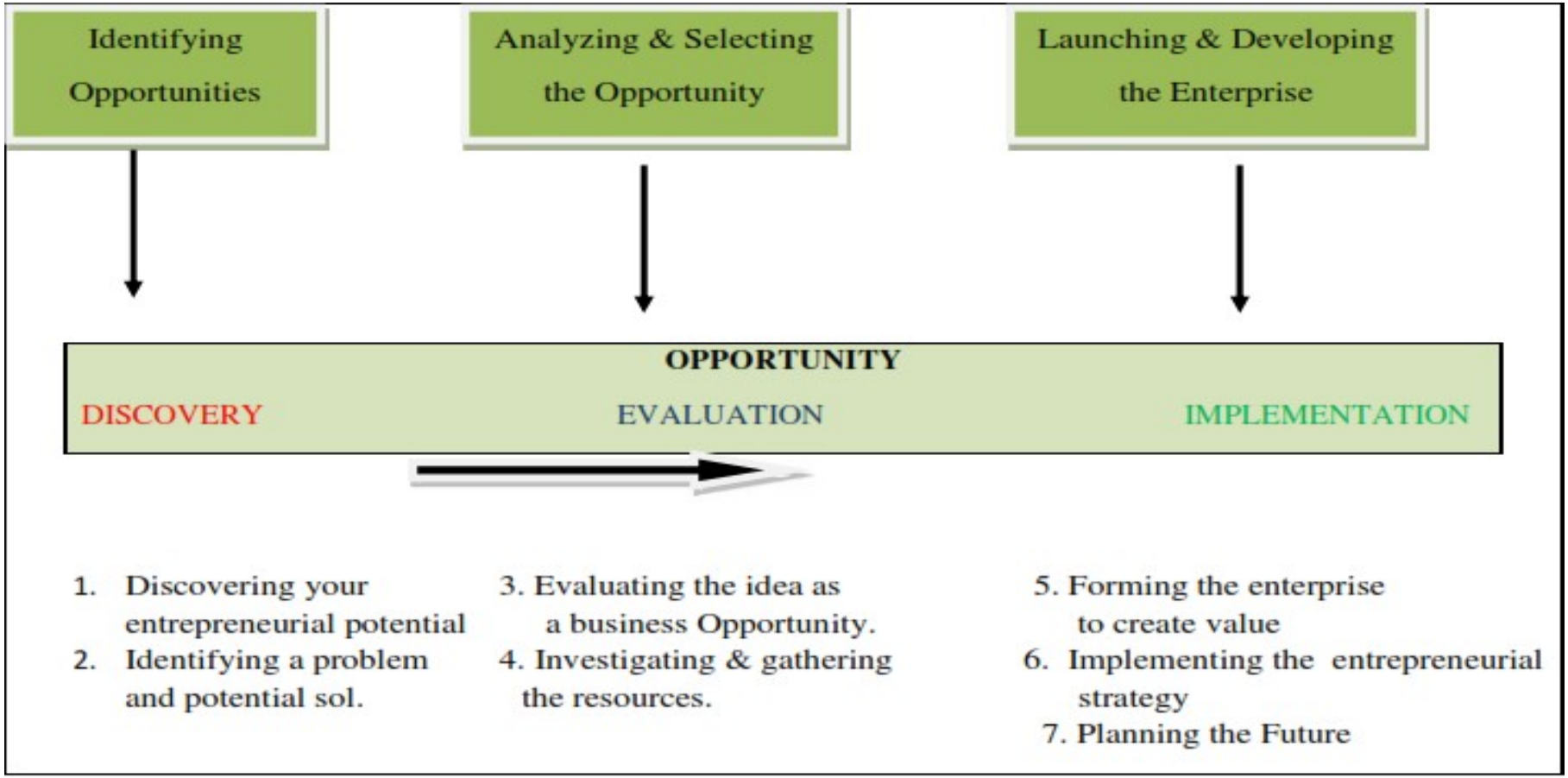
- ***Large Employment Opportunities:***
- ***Balanced Regional Development/ Removing Regional Imbalance***
- ***Equitable Distribution of Wealth and Decentralization of Economic Power***
- ***Unregulated Growth of Large-scale industries***
- ***Dispersal over Wide Areas***
- ***Higher Standard of Living***
- ***Mobilization of Locals Resources/Symbols of National Identity***

Con’t…

- ***Innovative and Productive /Simple Technology***
- ***Less Dependence on Foreign Capital/ Export Promotion***
- ***Promotion of Self Employment***
- ***Protection of Environment***
- ***Shorter Gestation Period***
- ***Facilitate Development of Large Scale Enterprises***
- ***Individual Tastes, Fashions, and Personalized Services***
- ***More Employment Creation Capacity***

3.5 Setting up Small Scale Business

The entrepreneurial process of launching a new venture can be divided into three key stages of: Discovery; Evaluation; and Implementation. These can be further sub-divided into seven steps as shown below:



Environmental Analysis

- For an analysis of the environment of entrepreneurship you would be required to develop an understanding of macroeconomic and industry/sector specific factors.
- **Macro Environment**
  - Consists of the political, technological, social, legal and economic environments.
- **Sectoral Analysis**
  - Study the sector or industry conditions in which the entrepreneur proposes to launch a venture.

SWOT Analysis

- A SWOT analysis helps the entrepreneur to clearly identify his/her own strengths and weaknesses as well as the opportunities and threats in the environment.

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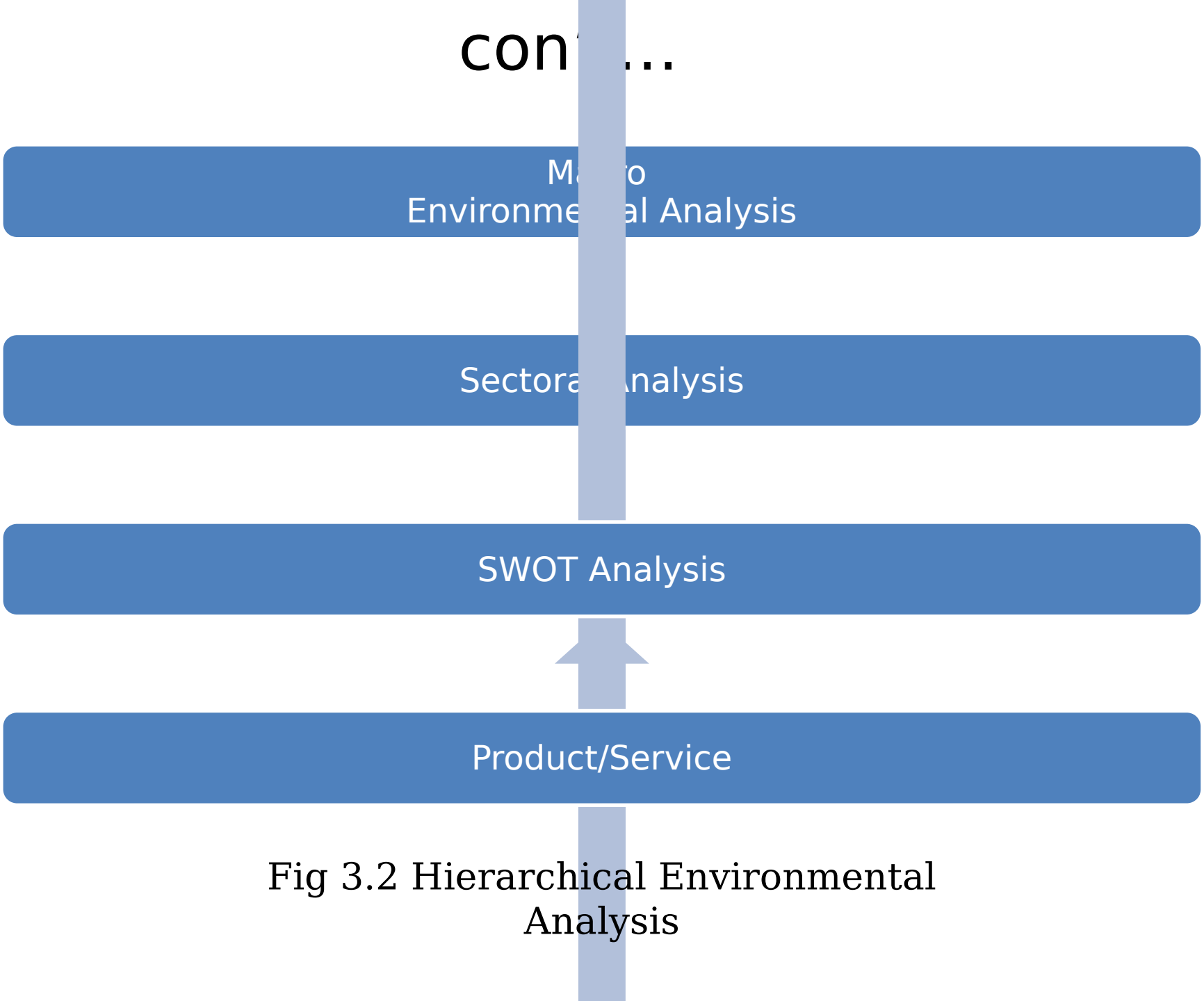

Fig 3.2 Hierarchical Environmental Analysis

3.6.1 Small Business Failure Factors

What Is Business Failure?

1) Actions such as *bankruptcy, foreclosure, or voluntary withdrawal from the business with a financial loss to a creditor* or

2) A Court action such as receivership (taken over involuntarily) or *reorganization* (receiving protection from creditors).

Causes of Business Failure

- ✓ The most common causes are inadequate management and financing.

I. Inadequate Management;

- 89 % of failure of the businesses is internal factors (controllable factors)
  - Adequate capital
  - Cash flow
  - Facilities/equipment
  - Inventory control
  - Human resources
  - Leadership
  - Organizational structure
  - Accounting systems

II. Inadequate Financing:

- Includes improper managerial control as well as shortage of capital.
  - You don’t have adequate funds to begin with, you will not be able to afford the facilities or personnel you need to start up the business correctly.
  - You do possess adequate capital but do not manage your resources wisely, you may be unable to maintain adequate inventory or keep the balance needed to run the business.

Con’t…

- In General, There are various causes of failure ;
  - Extend too
  - Much credit
  - Fail to plan for the future
  - Overinvest in fixed assets
  - Hire the wrong people.

Business Termination VS Failure

- A termination occurs when a business no longer exists for reasons of getting opportunity to sell for a profit, to move on to a new business , to retire, or lost interest in the business.
- If market for product have changed or become saturated, owner decided it would be more appealing to work for someone else.
- A business failure occurs when a business closes with a financial loss to a creditor.

Mistakes Leading to Business Failure

The most common mistakes are;

- Neglect to plan for the future
- Lack of commitment and hard work
- No delegation/ not hiring additional employees
- Inaccurate estimates of cash flow and capital requirements.

3.6.2 Small Business Success Factors

- Identifying failure factors can discover ways to tilt the scales towards success. These success factors are categorized as:-
  i. Conducive Environment;
  ii. Adequate Credit Assistance;
  iii. Markets and Marketing Support.

i. Conducive Environment

- *Political*, *economic*, *technological and socio-cultural factors*

ii. Adequate Credit Assistance

- *Adequate and timely supply of credit*
- *Special financing programs such as lower interest rates; less collateral requirements and lower equity ratio*;
- Various assistance schemes such as preparing the project study; etc.

iii.Markets and Marketing Support

- Small enterprises can sell their products as one body through closely-knit associations or organizations.
- The government assist small groups of entrepreneurs in selling their products.

Table 3.2. Improved definition of MSE

Level of Enterprise	Sector	Human Power	Total Asset
Micro Enterprise	Industry	≤5	Br ≤100,000
	Service	≤5	Br ≤50,000
Small Enterprise	Industry	6-30	Br ≤1,500,000
	Service	6-30	Br ≤500,000

- Priority Sectors and Sub-Sectors for MSEs Engagement In Ethiopia
  - *Manufacturing* Sector
  - Construction Sectors
  - Trade Sectors
  - Service Sectors
  - Agriculture Sector (Urban Agriculture)

- **Start-up**
- **Growth Level**
- **Maturity Level**
- **Growth- Medium Level**

3.8 Main Supporting Packages for MSEs Development in Ethiopia (Reading Assignment)

In Ethiopia supporting packages for MSEs includes;

- 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 are save 20% and the MFIs provide Loan 80% of the projects);
- Facilitate working premises; industry extinction 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 business.

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

Con’t...

- 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.
- How ever, Small business’s owner can avoid some of the common by knowing the business in depth; developing a solid business plan; managing financial resources; understanding financial statements; and learning to manage people effectively

3.10 Organizational Structure and Entrepreneurial Team Formation

3.10.1 Introduction

- We can perceive from the experiences of companies the importance of employees and their loyalty and commitment to the organization. Also 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 assumed that the management team is prepared to operate the business full time and at a modest salary. 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 design of the organization will be the entrepreneur's formal and explicit indication to the members of the organization as to what is expected of them. These expectations are grouped into five areas:-
  - *Organization structure*
  - *Planning, measurement, and evaluation schemes*
  - *Rewards*
  - *Selection criteria*
  - *Training*

3.9.3 Building the Management Team and a Successful Organization Culture

There are some important issues to address before assembling and building the management team. 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.

Con’t…

- Important considerations and strategies in recruiting and assembling an effective team and creating an effective and positive organization culture.
  1. The entrepreneur’s desired culture must match the business strategy outlined in the business plan.
  2. The leader of the organization must create a workplace where employees are motivated and rewarded for good work.
  3. The entrepreneur should be flexible enough to try different things.

Con't...

4. It is necessary to spend extra time in the hiring process.

5. The entrepreneur needs to understand the significance of leadership in the organization.

Generally, finding the most effective team and creating a positive organization culture is a challenge for the entrepreneur but is just as critical as having an innovative, marketable product. It is an important ingredient in an organization's success.

Thanks !