**CHAPTER 3: BUSINESS FORMATION**

**3.1 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.

**Legal Forms of Business Description**

1. Proprietorship Form of business with single owner who has  
    unlimited liability, controls all decisions, and receives all  
    profits.
2. Partnership Two or more individuals having unlimited liability who have  
    pooled resources to own a business
3. Corporation Separate legal entity that is run by stockholders having limited   
    liability

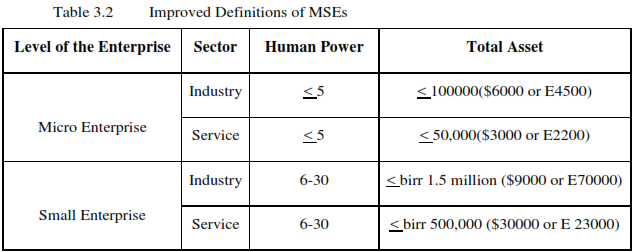
These three basic legal forms are compared with regard to ***ownership, liability, start-up costs, continuity, transferability of interest, capital requirements, management control, distribution of profits, and attractiveness for raising capital.***

It is very important that the entrepreneur carefully evaluate the pros and cons of the various legal forms of organizing the new venture. This decision should be made before the submission of a business plan and request for venture capital.

**3.2 Classification of Micro and Small Enterprises**

1. **In Case of Manufacturing Enterprise (Manufacturing, Construction and Mining):**
2. ***A Micro Enterprise*** is one in which the investment in plant and machinery (total asset) does not exceed birr100, 000 (one hundred thousand); and operates with 5 people including the owner.
3. ***Small Enterprises*** is one in which the investment in plant and machinery (a paid up capital of total asset) of birr100, 000 (one hundred thousand) and not more than Birr 1.5 million; and operates with 6-30 persons.
4. **In Case of Service Enterprise (Retailing, Transport, Hotel and Tourism, ICT and Maintenance):**
5. ***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.
6. ***Small Enterprises*** is one in which the total asset value or a paid up capital of birr100, 000 (one hundred thousand) and not more than Birr 1.5 million; and operates with 6-30 persons.

More clearly, the improved definition of MSE is presented in the table below.



When ambiguity is encountered between manpower and total assets as explained above, total asset is taken as primary yardstick.

**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 **s**ub-contracting; building materials; traditional mining works; cobble stone; infrastructure sub-contract; and prestigious goods
3. **Trade Sectors- This** is the one which compriseswhole 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.

**3.3** **Small Business Failure and Success Factors**

**3.3.1 Small Business Failure Factors**

**What Is Business Failure?**

Even though business owners launch their ventures with the best of intentions and work long, hard hours, some businesses inevitably fail. Dun & Bradstreet, a financial research firm, defines a business failure as a business that closes as a result of either (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 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.

Although financial problems are listed as the most common cause of business failure, consider management’s role in controlling them. Could business failure due to industry weakness be linked to poor management? Yes, if the owner tried to enter an industry or market with no room for another competitor or responded only slowly to industry changes. High operating expenses and insufficient profit margins also reflect ineffective management. Finally, business failure due to insufficient capital suggests inexperienced management.

***Inadequate Management: -*** *Business* management is the efficient and effective use of resources. For small business owners, management skills are especially desirable—and often especially difficult to obtain. Lack of experience is one of their most pressing problems. Small business owners must be generalists; they do not have the luxury of specialized management. On the one hand, they may not be able to afford to hire the full-time experts who could help avert costly mistakes. On the other hand, their limited resources will not permit them to make many mistakes and stay in business. As a small business manager, you will probably have to make decisions in areas in which you have little expertise.

Entrepreneurs are generally correct in pointing to internal factors as the reason for the failure of their businesses; these factors are the cause of 89 percent of such failures. Internal problems are those more directly under the control of the manager, such as adequate capital, cash flow, facilities/equipment inventory control, human resources, leadership, organizational structure, and accounting systems.

The manager of a small business must be a leader, a planner, and a worker. You may be a “top gun” in sales, but that skill could work against you. You might be tempted to concentrate on sales while ignoring other equally important areas of the business, such as record keeping, inventory, and customer service.

***Inadequate Financing: -***Business failure due to inadequate financing can be caused by improper managerial control as well as shortage of capital. On the one hand, if 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. On the other hand, if 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.

There are a lot of ways to fail in business. You can extend too much credit. You can fail to plan for the future or not have strategic direction. You can overinvest in fixed assets or hire the wrong people. Identifying mistakes that can be made is merely one component of the problem. Figuring out how to avoid them is the hard part.

**Other common causes of business failure include *Neglect, Fraud, and Disaster*.**

* *Neglect* occurs whenever an owner does not pay a due attention to the enterprise. The owner who has someone else managing the business while s/he goes fishing often finds the business failing because of neglect.
* *Fraud* involves intentional misrepresentation or deception. If one of the people responsible for keeping the business’s books begins purchasing materials or goods for himself or herself using the business's money, the business might find itself bankrupt before too long.
* *Disaster* refers to some unforeseen happening. If a hurricane hits the area and destroys the property in the company's yard, the loss may require the firm to declare bankruptcy. The same is true for fires, burglaries, robberies, or extended strikes.

**3.3.2 Small Business Success Factors**

When large and small businesses compete directly against one another, it might seem that large businesses would always have a better chance of winning. In reality, small businesses have certain inherent factors that work in their favor. You will improve your chances of achieving success in running a small business if you identify your competitive advantage, remain flexible and innovative, cultivate a close relationship with your customers, and strive for quality.

It may come as a surprise, but big businesses need small businesses a symbiotic relationship exists between them.

Small businesses perform more efficiently than larger ones in several areas. For example, although large manufacturers tend to enjoy a higher profit margin due to their economies of scale, small businesses are often better at distribution. Most wholesale and retail businesses are small, which serves to link large manufacturers more efficiently with millions of consumers spread all over the world.

Small business success factors can be seen the same as the efforts exerted in reversing the factors of failure. There are several positive steps in addition to planning that business owners can take to improve a firm’s chance for success.

From the discussion about factors of failure, we can conclude that a proper attitude is important to ensure a customer orientation for quality and service; the owner must have a purpose for being in business and want to provide customers with value for their money; and having a variety of basic business skill is important (such as the ability to keep accounting records.) So, by understanding why business fail, entrepreneurs can discover ways to tilt the scales towards success. These success factors are categorized as: -

* 1. Conducive Environment;
  2. Adequate Credit Assistance;
  3. Markets and Marketing Support.

1. **Conducive Environment**

Successful small enterprises do not emerge, and thereafter survive and grow unless the environment is conductive. *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.

**Political Climate: -** The overall political climate in a country is important for the small scale entrepreneur to consider. Small scale entrepreneur will need positive and encouraging measures by government and political constituencies to establish private investment. Such measures could include liberal or nonrestrictive investment policy, creation of promotional agencies, creation of industrial estates and free trade zones and availability of low-cost loan capital for private investors.

**The Economic Environment: - An** analysis of the economic environment is particularly helpful in investment decision, market measurement and in forecasting. The general state of the economy dictates what the small enterprise will need especially since it is handicapped in obtaining capital and credit owning to greater unit costs of small transactions, greater risks involved, etc.

**Technology: -** Technological advances in the environment create new needs for the small entrepreneur as far as adaptation and adjustment is concerned. Small scale entrepreneur needs to learn how to adjust to the new technological environment surrounding him/her, or needs to take a set of advance technologies and bring these to his/her own level in the small enterprise. Either way, constant reexamination is needed for possible utilization and improvement of existing technologies.

**Socio-Cultural Environment: -** Finally, the socio-cultural environment also creates a very important climate for the survival of the enterprises.

1. **Adequate Credit Assistance**

Small enterprise development cannot be ensured without arrangement for financing. Adequate and timely supply of credit is critical for new entrepreneurs to emerge especially from a wide base. A great majority of micro and small business activities have come about because of special financing programs offered to them. Thus, requirements are less strict in terms of lower interest rates than the prevailing commercial rates; less collateral requirements and lower equity ratio; various assistance schemes such as preparing the project study; etc.

1. **Markets and Marketing Support**

Market for a small enterprise in a developing country can be quite a problem. The small business entrepreneur will be in competition not only with locally mass-produced goods but even imports.

Small enterprises can brand together and sell their products as one body through closely-knit associations or organizations. The government too can take an active part in marketing specific products or assisting small groups of entrepreneurs in selling their products.