CHAPTER FOUR
ESTABLISHMENT OF ENTREPRENEURIAL FIRM

4.1 FORMS OF BUSINESS ORGANIZATIONS

One of the first decisions an entrepreneur faces when starting a new business, whether or not the business is small, is selecting the form of ownership for the new venture. Too often, entrepreneurs give little thought to choosing a form of ownership and simply select the form that is most popular, even though it may not suit their needs best. Although the decision is not irreversible, changing from one form of ownership to another once a business is up and running can be difficult, expensive, and complicated. That is why it is so important for an entrepreneur to make the right choice at the outset. This seemingly mundane decision can have a significant impact on almost every aspect of a business and its owner(s) – from the taxes the company pays and how it raises money to the owner's liability for the company's debts and the ability to transfer the business to the next generation. Each form of ownership has its own unique set of advantages and disadvantages. The key to choosing the "right" form of ownership is understanding the characteristics of each one and knowing how they affect an entrepreneur's business and personal circumstances. Although there is no best form of ownership, there may be a form of ownership that is best for each entrepreneur's circumstances.

The following are a few considerations that every entrepreneur should review prior to making the final form of ownership choice:

- **Tax considerations:** The graduated tax rate under each form of ownership, the government's constant tinkering with the tax code, and the year-to year fluctuations in the company's income mean that an entrepreneur must calculate the firm's tax bill under each ownership opinion every year.
- **Liability exposure:** Certain forms of ownership offer business owners greater protection from personal liability due to financial problems, faulty products, and a host of other difficulties. Entrepreneurs must decide the extent to which they are willing to assume personal responsibility for their companies' obligations.

- **Startup capital requirement:** Forms of ownership differ in their ability to raise startup capital. Depending upon how much capital an entrepreneur needs and where he/she plans to get it, some forms are superior to others.
- **Control:** By choosing certain forms of ownership, an entrepreneur automatically gives up some control of the company. Entrepreneurs must decide early how much control they are willing to sacrifice in exchange for help from other people in building a successful business.
- **Business goals:** How big and how profitable an entrepreneur plans for the business to become will influence the form of ownership chosen. Businesses often switch forms of ownership as they grow, but moving from some formats to others can be extremely complex and expensive.
- **Management Succession Plans:** When choosing a form of ownership, business owners must look ahead to the day will pass their companies on to the next generation or to a buyer. Some forms of ownership make this transition much smoother than others.
- **Cost of Formation:** Some forms of ownership are more costly and involved to create. An entrepreneur must weigh the benefits and the costs of the particular form he or she chooses.

Entrepreneurs have a wide choice of forms of ownership. In recent years, various hybrid forms of business ownership have emerged. This part will outline the key features of the most common forms of ownership, beginning with the sole proprietorship, the partnership, and the corporation.

4.1.1 SOLE PROPRIETORSHIP

The sole proprietorship is a form of business organization in which an individual introduces his capital, use of his own skill and intelligence in the management of its affairs and is solely responsible for the results of its operation. It is a form of business owned and managed by one individual. This form is known also as individual or single proprietorship, sole ownership or individual enterprise.

This form of business organization can be cited as the first stage in the evolution of the forms of business organization and this is the oldest and simplest among them. Establishing this business is easy and simple because the legal requirement is less. The individual himself provides the capital either from his personal saving or by borrowing from family or relatives.

The individual may run the business alone or take the help of the members of the family or may obtain the assistance of employees-like managers, specialist and others, the owner drives the total benefit and assumes the risk to which the business is exposed.

In the eye of the law, there is no distinction between the business and the individual's private affair, meaning that the law recognizes the individual and the business as being one and the same. Example: Photo studio, bookshop, bakeries, small town restaurants, retail stores, radio and watch repair shops, and other elementary forms of business where personal service is important. The proprietorship is the simplest and cheapest way to start operation and is frequently the most appropriate form of a new business.

Commentary: *No, because a sole proprietorship business has no legal body. Therefore, the owner of the business is liable to the extent of his or her other assets if the capacity of the business is not sufficient to meet its financial obligations.*

4.1.2 PARTNERSHIP

The association of two or more persons to carry on as co-owners of a business where the relationship is based on agreement is called partnership. This form of a business requires the existence of two or more persons entering into a contractual relationship. This contract, which is an agreement between the parties, is known as a memorandum of association or article of partners' deed.

4.1.2.1 KINDS OF PARTNERS

The individuals who comprise a partnership are known as partners, or copartners. They may be classified in several different ways. The most common types of partners are the following:

1**. A general partner-** assumes unlimited liability and is usually active in managing the business. Most partners are general partners.

2. **A limited or special partner-** assumes limited liability, risking only his /her investment in the business. Limited partners may not be active in management, and their names are not used in the name of the business.

3. A secret partner- takes an active role in managing a partnership but whose identities are unknown to the public. i.e the general public does not know of this person's partnership status.

4. **A silent partner-** as opposed to a secret partner, a silent partner, his identities and involvement, is known to the general public, but is inactive in managing the partnership business.

5. **A dormant or sleeping partner-** is nether known to the general public nor is active in management

6. **Nominal partners-** are not actually involved in a partnership but lend their names to it for public relations purposes but invest no money in the firm and play no role in its management. These are not partners but who claim they are or allow others to think of them as partners. Such individuals may assume some of the responsibilities of general partners.

7. **Senior partners-** assume major roles in management because of the long tenure (possession), amount of investment in the partnership, or age. They normally receive large shares of the partnership's profits.

8. **Junior partners -** are generally younger partners in tenure, have only small investment in the firm, and are not expected to make major decision. They assume limited role in the partnership's management and receive a smaller share of the partnership's profits.

4.1.2.2 TYPES OF PARTNERSHIP

There are two common types of partnerships: General partnership and Limited partnership

General partnership (Ordinary partnership)

They have the right to participate actively in the management affair of the business. If the assets available in the business are not sufficient, debt coverage goes to the extent of their personal assets. The partner faces the risk of implied authority. i.e the partner is liable for the wrongful acts of a copartner in the operation of the business.

Limited partnership

They cannot take part on the management of the business and their act does not bind the firm since their liability is limited, their rights are also restricted. The liability of the limited partners is limited to the extent of their investment in the firm. If the business fails, creditors cannot claim their personal property. They do not play an active role in the operations of the business. Basically limited partners are needed to increase the capital of the business.

4.1.3 CORPORATION

The corporation is the most complex of the three major forms of business ownership. Corporation can be defined as an artificial being, invisible, intangible, and existing only in the contemplation of the law. In other words a corporation is an artificial person authorized and recognized by law, with distinctive name, a common seal, comprising of transferable shares of fixed values, carrying limited liability and having a perpetual or continued or uninterrupted succession life.

4.1.3.1 Characteristics of Corporation

Separate legal entity: It can sue or be sued. It has the right to manage its own affairs. Shareholders cannot be liable for the acts of the corporation

Limited liability: Since the corporation has separate legal entity its debts are its own. The assets and liabilities, rights and obligations incidental to the company's activities are assets and liabilities, rights and obligations respectively of the company and not of its members.

Transferability of shares: It is easy to transfer ownership in a corporation. A stockholder may sell stock to another person and transfer the membership and membership interest freely without consulting other stockholders.

Perpetual existence: Death, insanity, retirement and withdrawal of shareholders will not affect the company.

Common seal: A corporation has a common seal with the name of the company engraved on it, which is used as a substitute for its signature through it acts through its agents.

Separation of ownership from management: All shareholders, large in numbers, do not have the opportunity of managing the day-to-day activity of the corporation. A company cannot, as an artificial person, manage itself. It must therefore have managers, or directors. Directors are the persons to whom management of a company is entrusted. Directors may be appointed and removed by a simple majority vote of the shareholders. Except in very small corporations, most stockholders are not directly involved in the management of the company. The company is free to hire any employee it can afford and is thus able to get the specialized professional skills needed for sound management.

Supervision: A company is created by the legal process of incorporation. While it exists, it is subject to detailed regulation; for instance, it must prepare and deliver to the registry annual accounts and an annual return (a summary of its situation). The Registrar of Companies, the Department of Trade and Industry and the courts all may have power of regulation and investigation over companies.

Written Constitution: On the creation of a company, the promoters must file certain documents with the Registrar of Companies. These include the Article of Association and the Memorandum of Association.

Commentary: *The death of the owner does not affect the operation of a corporate business. This can be due to the nature of the business itself. Therefore, address the question from the features of corporation.*

4.2. FUNDING AND FINANCING OF NEW VENTURE

New and growing ventures require financing for a variety of needs as they develop over time (Table 4.1). These needs are a function of the type of venture, the rate of growth, and the stage of the venture's development. Low growth firms, for example, require smaller amounts of funding than do higher-growth firms. Service ventures require less than manufacturing firms. Ventures poised to enter their rapid growth stage will require more funds than one which has just been launched.

Pre start-up capital is the investment required long before the venture is launched. If a new product is involved, prototype development must come before the venture is launched. Significant research and development and market research may be necessary. Funds for strategic plan development and initial site acquisition may also be necessary at this time.

Startup expenses are those costs incurred shortly before, during, and immediately after the actual launch of the venture. Expenditures at the time of start-up include facilities and equipment, inventory, grand opening advertising, prepaid expenses such as deposits and insurance, licenses, and professional fees for accountants and attorneys.

Additional funding will be necessary once the venture is begun. Typical operating expenses such as advertising, additional inventory, salaries, and sales expenses are included here. Of particular interest is the need to balance seasonal or cyclical cash flow deficits.

Virtually all businesses will have uneven cash flows. The purchase of inventory is an example of this since inventory must be purchased weeks or months before it can be sold. Thus, inventory financing becomes the major financing need for most retail businesses as well as for many manufacturing ventures.

Stage of development	**Financing needs**
Pre-start-up	prototype development, site acquisition, business plan preparation, research and development, market research
Start-up	Inventory, plant and equipment, grand opening advertising, professional fees, prepaid expenses
Post-start-up	Advertising, sales expenses, wages and salaries, rent, utilities, additional inventories, seasonal/cyclical cash flow needs
Growth	Facility expansion, additional distribution methods, geographical expansion, acquisitions, cost of underwriting more financing

Table 4.1 Financing needs for various stages of development

Low-growth small businesses typically do not need substantial funding once the initial launch and stabilization occur. Moderate or high growth ventures on the other hand, will require major additional inflows of capital to underwrite expansion. Additional plant and equipment may be required, additions or changes in distribution system may be costly, geographical expansion can absorb significant funding, acquisition of other firms can be quite expensive, and substantial funding may be required before going public.

Some of the financing needs will be short term. Other needs can be met only using long-term financing methods. Short-term capital may be that which is necessary to launch the venture or to finance development costs before the venture is formally launched. Long-run capital is typically used to finance fixed equipment and facilities or major research and development effort.

4.2.1 SOURCES OF FINANCE

There are two basic sources of financing: equity and debt. **Equity financing** is capital provided in exchange for ownership. **Debt financing** is provided to the venture in exchange for interest payment and does not include the ownership provision. The following section presents different sources of finance.

4.2.1.1 DEBT FINANCING

Debt capital is the financing that a small business owner has borrowed and must repay with interest. Small enterprises have fewer choices than large firms for obtaining debt financing. They are excluded from financial sources such as money raised through the sale of bonds debentures, and commercial papers. Also, many small businesses are limited by size; with small inventories or markets that provide few assets for collateralizing loans. Very few entrepreneurs have adequate personal savings to finance the complete start up of a small business; many of them must rely on some form of debt capital to launch their companies. Lenders of capital are more numerous than investors, although small business loans can be just as difficult (if not more difficult) to short-term borrowing (one year or lasses) is often required for working capital and is repaid out of the proceeds from sales. Long-term debt (term loans of one to five years or long term loans maturing in more than five years) is used to finance the purchase of property or equipment, with the purchased asset serving as collateral for the loans. Although borrowed capital allows entrepreneurs to maintain complete ownership of their business, it must be carried as a liability on the balance sheet as well as be repaid with interest at some point in the future. In addition, because lenders consider small businesses to be greater risks than bigger corporate customers, they require higher interest rates on loans to small companies because of the risk return trade off_ the higher the risk, the greater the return demanded. Most small firms pay the prime rate the interest rate banks charge their most credit worthy customers-plus a few percentage points. Still, the cost of debt financing often is lower than that of equity financing. Because of the higher risks associated with providing equity capital to small companies, investors demand greater returns than lenders. Also unlike equity financing, debt financing does not require an entrepreneur to dilute her/his ownership interest in the company.

4.2.1.2 EQUITY FINANCING

Equity financing represents the personal investment of the owner (or owners) in a business, and it is sometimes called **risk capital** because these investors assume the primary risk of losing their funds if the business fails. However, if the venture succeeds, they also share in the benefits, which can be quite substantial. The use of equity capital thus requires no repayment in the form of debt. It does, however, require entrepreneurs earnings (if there are any) and usually to have a voice in the business's future directions. In short, it requires sharing the ownership and profits with the funding sources. Since no repayment is required, equity capital can be much safer for new ventures than debt financing. Yet the entrepreneur must consciously decide to give up part of the ownership in return for funding. Although 50 percent of something is better than 100 percent of nothing, giving up control of your business can be disconcerting and dangerous.

Some specific sources of equity financing:

- Personal Savings
- Friends and family
- Angels (private investors
- Partners
- Venture Capital Companies (private, for profit organizations that purchase equity)
- Public Stock Sale ("going public")

- ***Commentary:*** *There are a number of sources for equity financing. When you arrange there several sources of equity finance as per their order of importance you should consider the extent to which the sources help the owners to avoid conflict in the decision making process.*

4.3. ORGANIZING THE VENTURE

4.3.1 LEGAL ISSUES FOR THE ENTREPRENEUR

In establishing a new venture, the entrepreneur should deal with various legal issues. Understanding the legal issues involved in entrepreneurship and taking appropriate measures protect the entrepreneur from later legal complications which might hinder the smooth running of the new business. In this regard, the entrepreneur must seek the assistance of a competent attorney who is in a better position to understand all possible circumstances and outcomes related to any legal action.

Some of the legal issues the entrepreneur should address in starting a new business are discussed below.

1. **Intellectual Property**: it refers to exclusive right given to the entrepreneur to benefit from his/her innovations and creations; and this includes: patents, trademarks, copy rights, and trademarks. These are very important assets to the entrepreneur and must be understood even before engaging the services of an attorney. Too often entrepreneurs, because of the lack of understanding of intellectual property, ignore the important steps to take in order to protect these assets.

- **Patents:** A patent is a contract between the government and an inventor. In this contract, the inventor agrees to disclose his/her invention in return for grants by the government exclusivity regarding the invention for a specified period of time. At the end of this time the government publishes the invention and becomes part of the public domain.

The regulations concerning patent were issued by the transitional government of Ethiopia under the proclamation No.123 in 1995 GC. The Ethiopian government grants patents for machines, compositions of matters such as chemical compounds to be used in an industry, manufactured items, and industrial processes, provided that they meet a number of legal conditions. Patents are also available for significant improvements on previously invented items and for certain types of industrial designs. Currently, the Ethiopian Science and Technology Institution is the central government office responsible for the determination of the validity of patents.

Importance of patents: having laws and regulations concerning patent and other intellectual properties benefits both the country and the individual entrepreneur in a number of ways:

- ✓ It is necessary to create favorable conditions in order to encourage local inventive and related activities thereby building up national technological capabilities.
- ✓ It has been found essential to encourage the transfer and adaptation of foreign technology; by creating a good environment to assist the national development efforts of the country.
- ✓ The task of fulfilling the nation's multidimensional demand for harmonious scientific and technological progress, to be used for the public benefits, shall be most effectively served when there exists an appropriate legal frame work.

Application to get a patent: to obtain a patent in Ethiopian an individual must write an application to the Ethiopian Science and Technology Institution. The application should have three parts:

- ✓ **Introduction:** it should contain the back ground and advantages of the invention and the nature of problems that it overcomes. It also should clearly state how the invention differs from existing offerings.
- ✓ **Description of the invention:** the application should also contain a brief description of the drawings that accompany it. Then, this should be followed by a detailed description of the invention, which may include engineering specifications, materials, components, and so on, that are vital to the actual making of the invention.
- ✓ **Claims:** claims serve as the criteria by which any infringements will be determined. They serve to specify what the entrepreneur is trying to patent. Essential parts of the invention should be described in broad terms so as to prevent others from getting around the patent. At the same time, the claims must not be so general that they hide the invention's uniqueness and advantages.

Patentable invention: to qualify for a patent, an invention must fulfill the following:

- ✓ An invention is patentable if it is new, involves an inventive step, is industrially applicable
- ✓ An invention shall be considered new if it is not anticipated by prior art. Prior art shall consist of everything disclosed to the public, anywhere in the world by publication in tangible form or by oral disclosure, by use or any other way, prior to the application or, where appropriate, the priority date of the application claiming the invention.
- ✓ Notwithstanding the above provision, the disclosure to the public of the invention shall not be taken in to consideration if it occurred with in the 12 months preceding the filing date or where applicable, the priority date of the application, and if it was by reason or in consequence of acts committed by the applicant or his predecessor in title partly with regard the applicant or his predecessor in title.
- ✓ An invention shall be deemed as involving an inventive step if, having regard to the prior art relevant to the application and defined in the second criterion above, it would not have been obvious to a person having ordinary skill in the art

- ✓ An invention shall be considered industrially applicable when it can be made or used in handicraft, agriculture, fishery, social services or any other sector

Non patentable invention: as per the patent regulations of Ethiopia the following inventions shall not be granted patent protections:

- ✓ Inventions contrary to pubic order or morality
- ✓ Plant or animal varieties or essentially biological processes for the production of plants and animals
- ✓ Schemes, rules, or methods for playing games or performing a commercial activity
- ✓ Discoveries of scientific theory and mathematical methods
- ✓ Methods for the treatment of the human or animal body by surgery or therapy, as well as diagnostic method practiced on a human or animal body

Disputes: Occasionally, several people apply for a patent for the same invention. Under the Ethiopian law, the person who first invented the item receives the patent. If it is unclear who invented the item first, the ESTI decides who gets the patent in a proceeding called interference. The losing party can appeal the decision in the court of appeals. Most other countries grant the patent to whoever first applied for the patent protection.

Terms: If the ESTI finds that the invention fulfills the conditions listed above, grants the patent. Under the current Ethiopian law, a patent is given for five years to the individual or individuals who came up with the invention. However, if the inventor is an employee and did the work as part of his/her job, the grant will be given to the employer too.

Infringement: It refers to the act of making, using, or selling a patented invention without the consent of the patent holder. Anyone who infringes a patented invention is susceptible to a legal action by the patentee-the holder of the patent. The infringer might argue that the patent should not have been given in the first place and it will be up to the court to decide whether or not the patent is valid. Another defense that can be used by the infringer is the first sell principle. Under this principle, once the patentee sells a particular item, the purchaser of that item may use it or resell it without being considered an infringer.

Options to avoid infringement: to avoid risks that are associated with patent infringement, the entrepreneur should follow the following procedures:

- ✓ Assess whether the item is patented or not

- ✓ If not patented, file for patent
- ✓ If a patent exists, determine whether the patent is new or nearly expired
- ✓ If it is nearly expired, plan for introduction when the patent expires
- ✓ If it is new, determine if other expired patents exist that accomplish the same purpose
- ✓ If yes, develop the product using other designs
- ✓ If no, see if it is possible to introduce some changes in the product and commercialize it without infringement
- ✓ If this is not possible, seek a license from the patentee
- ✓ If it is possible, produce using the modified version

- **Trademarks:** It may be a word, symbol, design, or some combination of such, or it could be a slogan or even a particular sound that identifies the source of the sponsorship of certain goods or services. Unlike the patent, trade mark can last indefinitely, as long as it continues to perform its indicated function.

  Most countries of the world legally protect trademarks. The current Ethiopian law also gives companies the right to register their trademarks and have them protected. Trade mark registration is carried out by the Ministry of Inland Revenue; and to be eligible for registration the mark must be used in internal or foreign commerce.

  The owner of a trade mark may permit others to use it by granting them a license in return for a royalty's fee. The owner of the trade mark must supervise the licensees to make sure that they provide a consistent type and quality of goods and services. Failure to supervise can result in loss of rights to the trade mark.

  Sometimes the public may stop thinking of the trade mark as a brand name and begins to think of it merely as a general category of goods. The trade mark owner has a responsibility to make sure that this does not happen. If the trade mark owner fails to do so, he/she will lose his/her legal rights to the trade mark because the source of the good or service can no longer be identified.

  The law forbids the use of someone else's trade mark in a way that confuses the public about the source of the product. And, anyone who does this is considered an infringer and can be sued by the trade mark owner.

- **Copy right:** It refers to the right given to prevent others from printing, copying, or publishing any original work of authorship. The protection in a copy right does not protect the idea itself, and thus it allows someone else to use the idea or concept in a different manner.
- **Trade secrets:** In certain instances, the entrepreneur may prefer to maintain an idea or process as confidential and sell or license it as a trade secret. The trade secret will have a life as long as the idea or process remains a secret. Employee involved in working with an idea or process may be asked to first sign a confidential information agreement that will protect against their giving out the trade secret either while an employee or after leaving the organization. The entrepreneur should hire an attorney to help draw up any such agreement. The holder of the trade secret has the right to sue any signee who breaches such an agreement.

  What or how much information to give to employees is difficult to judge and is often determined by the entrepreneur's judgment. Historically, entrepreneurs tend to protect sensitive or confidential company information from anyone else by simply not making them privy to this information. Today, there is a tendency to take the opposite view that the more information entrusted to employees, the more effective and creative employees can be. The argument is that the employees cannot be creative unless they have a complete understanding of what is going on in the business.

2. **Contracts:** the entrepreneur, in starting a new venture will be involved in a number of negotiations and contracts with vendors, land lords, and clients. A contract is a legally enforceable agreement between two or more parties as long as certain conditions are met. It is very important for the entrepreneur to understand the fundamental issues related with contracts while also recognizing the need for a lawyer in many of these negotiations.

   Conditions that must be fulfilled for a contract to be legally enforceable:

   - ✓ **Capacity:** the parties in a contractual agreement must have the legal capacity to participate in contracts. A person is legally capable of singing contracts if his 18 years of age or older, sane, and not judicially interdicted.

- ✓ **Consent:** for a contract to be enforceable; it must be made out of the consent of the parties involved; and this includes agreement and intention.
- ✓ **Object:** it refers to the obligation to perform or pay; that is to deliver the price of the said thing or object. The object of a contract must be legal and possible. You cannot enter in to a contract to do the impossible or illegal things.
- ✓ **Form:** contracts can be either written or oral depending on the nature of the agreement.