Course 3: BUSINESS FORMATION

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. This course discusses the issues of business development and the different legal forms of business. In addition, the concept of MSEs in the regional and international context are discussed. The importance/roles of MSEs and a business formation deal with the formalization and actual implementation of business ideas in to practice. This course discusses the issues of business development and the different legal forms of business. In addition the concept of MSEs in the regional and international context are discussed. The importance/roles and set up of MSEs are discussed very well. Besides the success and failure factors of MSEs and the common problems of MSEs in region are discussed. Furthermore, the course highlights the reality in the era of entrepreneurship environment as, not only are the skills and abilities important, but the entrepreneur also will need to consider the personality and character of each individual to create a viable organization culture.

Course Objectives

After completing this course, students will be able to:

- Explain the Concept of Business Development;
- Identify the Forms of Business Ownership;
- Analyze the Importance/Role of MSEs;
- Set Up Small Scale Business;
- Distinguish the Failure and Success Factors of MSEs;
- Identify the Problems of Small Scale Business in region; and
- Develop Organizational Culture.

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. Size does not always reflect the true nature of an enterprise; in addition, qualitative characteristics are used to differentiate small business from other business. The economic/control definition covers market share, independence and personalized management.

Micro and small enterprises (MSEs) cover a wider spectrum of industries and play an important role in both developed and developing economies. region is no exception and MSEs occupy a prominent position in the development of the regional economy. While the small entrepreneurs can set up a unit even with 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,. The process of setting up a venture begins with searching for an opportunity. Identifying a good opportunity is a difficult task and involves scanning the environment and the use of creativity and innovation.

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.

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.

The comparison for the three basic legal forms against the aforementioned factors is briefly presented in the table below:-

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.

LLP- Limited Liability Partnership

4. Definition and Role/Importance of MSEs in Developing Countries

1. Definition of MSEs

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.

However, some discernible characteristics still differ them. Most small businesses' 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; hence, their strategy calls for continuous work on mitigating uncertainty and risk reduction.

Specifying size and standard to define small business is necessary because people adopt different standards for different purposes. For example, legislators may exclude small firms from certain regulations and specify ten employees as the cut-off point. Moreover, a business may be described as “small” when compared to larger firms, but “large” when compared to smaller ones. For example, most people would classify independently owned gasoline stations, neighborhood restaurants, and locally owned retail stores as small business.

Similarly, most would agree that the major automobile manufacturers are big businesses. And firms of in-between sizes would be classified as medium on the basis of individual viewpoints. 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.

Even though the number of employees-is the most widely used yardstick, the best criterion in any given case depends upon the user’s purpose. To provide a clearer image of the small firms, the following general criteria for defining a small business are suggested by Small Business Administration (SBA).

- 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 MSEs 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 MSEs.

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, and

- Personalized Management.
- Geographical Area of Operation.

All four of these characteristics must be satisfied if the business is to rank as a small business.

I) ***Market Share*: -** The characteristic of a small firm's share of the market is that it is not large enough to enable it to influence the prices of national quantities of goods sold to any significant extent.

II) ***Independence*: -** Independence means that the owner has control of the business himself/herself. It, therefore, rules out those small subsidiaries which though in many ways fairly autonomous, nevertheless have to refer to major decisions (e.g., on capital investment) to a higher level of authority.

III) ***Personalized Management: -*** It is the most characteristics factor of all. It implies that the owner actively participates in all aspects of the management of the business, and in all major decision-making process. There is little delegation of authority and one person is involved when anything material is involved.

IV) ***Technology*: -** Small business is generally labor intensive and only few are technology intensive.

V) ***Geographical Area of Operation*: -** The area of operation of a small firm is often local.

Generally, small business is a business that is privately owned and operated, with a small number of employees and relatively low volume of sales.

2. Role/Importance of MSEs in Developing Countries

Micro and Small Enterprises (MSEs) cover a wider spectrum of industries and play an important role in both developed and developing economies. region is no exception and MSEs occupy a prominent position in the development of the regional economy. Over the years, the number of MSEs 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. For every fixed amount of investment, MSE sector provides employment for more persons as against few persons in the large scale sector. Thus in a country like region where capital is scarce and labor is abundant, MSEs are especially important.
2) **Economical Use of Capital**: MSEs need relatively small amount of capital. Hence it is suitable to a country like region where capital is deficient.

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. region is a land of villages.

Another problem is the continuous shifting of people from rural to urban areas which causes over-crowding in cities with slum conditions due to lack of social and medical amenities which require heavy investments. This problem can be solved by inducing people to set up micro and small firms in rural areas.

Large scale industries have the tendency to concentrate in big cities. As a result, semi urban and rural areas remain deprived of the benefits of industrialization. Moreover, undue concentration of large industries in urban areas creates several problems, e.g., pollution, shortage of civic facilities, etc. Due to lack of employment opportunities in the country side, people migrate in large numbers to big cities. Micro and small-scale units can be located in rural and semi urban areas to reduce regional disparities.

4) **Equitable Distribution of Wealth and Decentralization of Economic Power**: It removes the drawbacks of capitalism, abnormal profiteering, concentration of wealth and economic power in the hands of few etc.
5) **Unregulated Growth of Larg**e-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. This is due to wide spread ownership and decentralized location of small scale enterprises. In this way, small & medium scale enterprises bring about greater equality of income distribution. It is also argued that most of the micro and small scale units are either proprietary or partnership concerns. As a result, relations between workers and employers are more harmonious in micro and small enterprises than in large enterprises. Micro and small enterprises also encourage competitive spirit and generate the impetus to self-development.
6) **Dispersal over Wide Areas**- MSEs 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.

Small scale businesses are locally owned and controlled, and can strengthen family and other social systems and cultural traditions. They are perceived as valuable in their own right as well as symbols of national identity.

9) **Innovative and Productive /Simple Technology**: New but simple techniques of production can be adopted more easily by MSEs without much investment.

Small businesses are highly innovative though they do not maintain their own research and development.

10) **Less Dependence on Foreign Capital/ Export Promotion**: MSEs use relatively low proportion of imported equipment and materials. The machinery needed for these industries can be manufactured within the country. Micro and small scale enterprises are opening up fresh avenues in the export market in our world. Realizing the importance of the small and medium- scale sectors in the economy; the regional government has adopted several measures to speed up the growth of micro and small size enterprises.
11) **Promotion of Self Employment**: MSEs foster individual skill and initiative and promote self-employment particularly among the educated and professional class.
12) **Protection of Environment**: MSEs help to protect the environment by reducing the problem of pollution.
13) **Shorter Gestation Period**: In these enterprises the time-lag between the execution of the investment project and the start of flow of consumable goods is relatively short.
14) **Facilitate Development of Large Scale Enterprises**: MSEs support the development of large enterprises by meeting their requirements of inputs of raw materials, intermediate goods, spare parts etc. and by utilizing their output for further production.
15) **Individual Tastes, Fashions, and Personalized Services**: Small businesses have the flexibility to adapt quickly to changes in the business or technological environment.
16) **More Employment Creation Capacity**: Economic planners have realized the necessity of encouraging micro and small enterprises because they require less capital but generate more employment. The micro and small scale sectors have the capacity to generate a much higher degree of employment than the large-scale sector. This is because micro and small

scale enterprises are labor intensive and thus create more employment with a given level of capital. More production needs more capital in such a situation. The micro and small firms will stand in good position because they are less capital intensive and more labor intensive.

3.5 Classification of Micro and Small Enterprises

1. **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 birr100, 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 birr100, 000 (one hundred thousand) and not more than Birr 1.5 million; and operates with 6-30 persons.
2. **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 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.

Table 3.2 Improved Definitions of MSEs

Level of the Enterprise	**Sector**	**Human Power**	**Total Asset**
Micro Enterprise	Industry	≤ 5	≤ 100000($6000 or E4500)
	Service	≤ 5	≤ 50,000($3000 or E2200)
Small Enterprise	Industry	6-30	≤ birr 1.5 million ($9000 or E70000)
	Service	6-30	≤ birr 500,000 ($30000 or E 23000)

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 region

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 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.

- **Levels of MSEs in region**

Start-up:- Start up level refers to enterprises that incorporate people who are interested to establish MSE and those who completed the required profession/skill from various institutions and innovated by legally either in the form of association or private. It is a level where an enterprise begins production and service under legal framework or legal entity.

Growth Level: - An enterprise is said to be at growth level when an enterprise become competent in price, quality and supply and profitable using the support provided. At this level, the enterprise man power and total asset is larger than at startup level; and use book keeping system.

Maturity Level: - Maturity level means when an enterprise able to be profitable and invest further by fulfilling the definition given to the sector and using the support provided.

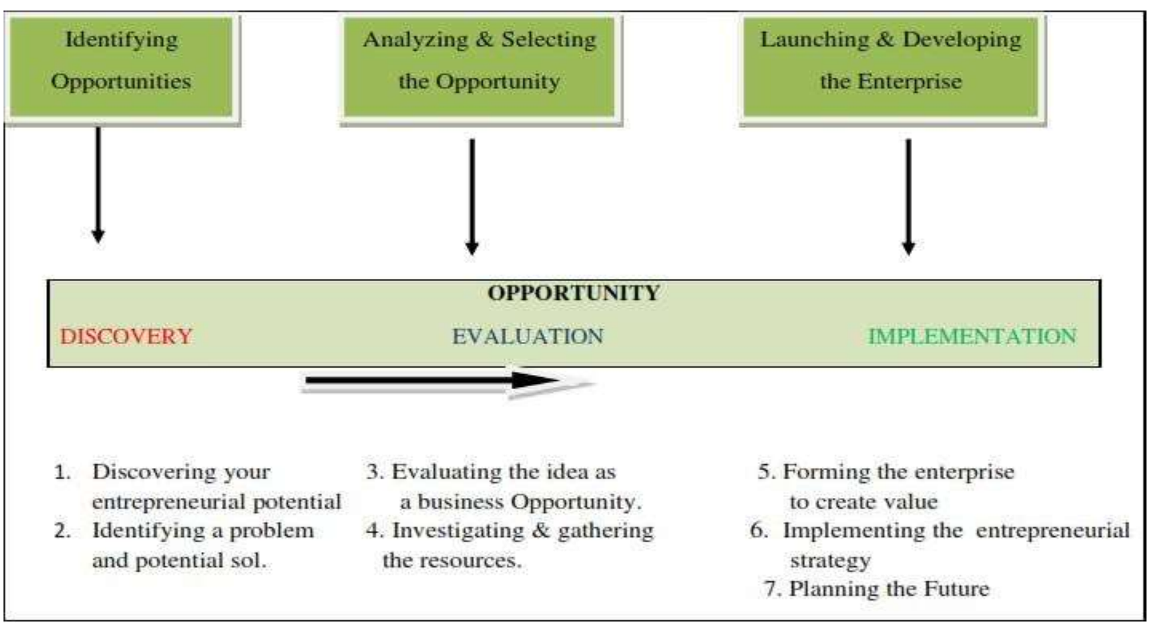
Growth- Medium Level:- An enterprise is said to be transformed from small to medium level of growth is when it enabled to be competent in price, quality and supply using the support given to the level.

3.6 Setting up Small Scale Business

Steps for Setting up the Entrepreneurial Venture

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. However, setting up of a small new enterprise is a very challenging as well as a rewarding task. Several problems are involved in this task. It is extremely important to take utmost care in identifying the product or service to be launched by the entrepreneur; otherwise it might prove to be a costly mistake. After tentatively identifying four to five ideas, s/he should go in for detailed assessment and feasibility study. This will help the entrepreneur to crystallize one idea in an objective and systematic manner, which will greatly enhance his/ her chances of success.

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:



Discovery: The first stage of discovery is to identify opportunities that may form the basis of an entrepreneurial venture. It requires creative thinking to indentify issues that can benefit from an entrepreneurial vision. This stage can be divided into two steps:

Step 1 Discovering your entrepreneurial potential - the first step is to know more about your personal resources and attributes through some self-evaluation– what will you bring to the venture? What are your strengths and challenges? These will affect the type of venture you choose.

Step 2 Identifying a problem and potential solution – a new venture has to solve a problem and meet a genuine need.

Evaluation: By the end of first stage of discovery, you should have selected an idea worthy of further detailed investigation. The next stage evaluates if this all adds up to a feasible business in two further steps:

Step 3 Evaluating the idea as a business opportunity– find out information about the market need. Is the solution to this problem really wanted by enough customers? Investigate the feasibility of the proposed solution (technically, economically, socially, and legally).

Step 4 Investigating and gathering the resources – How will the product/service get to market? How will it make money? What resources are required?

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. The next stage is to make the final preparations and launch it into the market. It can be developed in three further steps:

Step 5 Forming the enterprise to create value – set up a business entity and protect any intellectual property. Get ready to launch the venture in a way that minimizes risk and maximizes returns.

Step 6 Implementing the entrepreneurial strategy – activate the marketing, operating, and financial plans.

Step 7 Planning the future – look ahead and visualize where you want to go.

Environmental Analysis: Entrepreneurship does not exist in a vacuum. It is affected by and affects the environment. Relationship between entrepreneurship and environment is shown in the figure below.

Figure 3.1 Entrepreneurship vs Environment

As the economies are getting internationally integrated, for an analysis of the environment of entrepreneurship you would be required to develop an understanding of macroeconomic, and industry/sector specific factors.

a) Macro Environment

The macro environment of an entrepreneur consists of the political, technological, social, legal and economic environments. All of these are not immediate part of the entrepreneur's venture yet they have an impact on his/her enterprise.

b) Sectoral Analysis

After having understood the general environment in which the business has to take birth, it is important to study the sector or industry conditions in which the entrepreneur proposes to launch a venture. This will help to put the proposed venture in the proper context. The purpose of industry analysis is to determine what makes an industry attractive- this is usually indicated either by above normal profits or high growth rates. For such analysis one should study the history of the industry, the future trends, new products developed in the industry, forecasts made by the government or the industry. It is also advisable to study the existing or potential competition, threat of substitutes and entry barriers. Sometimes there might be bilateral agreements between countries regarding some sectors or government policy that is sector specific or some event that throw up challenges.

There might be certain constraints regarding availability of technology, manpower or raw materials, which are industry specific. Similarly, there might be certain strengths of a particular sector, which might outweigh some negative general trends. ***For instance,*** currently the cement and steel sector are on an upward swing with a favorable climate in the housing sector as well as government's thrust on the construction sector.

SWOT Analysis

At this stage, conducting a SWOT analysis will help the entrepreneur to clearly identify his/her own strengths and weaknesses as well as the opportunities and threats in the environment.

Strengths are positive internal factors that contribute to an individual's ability to accomplish his/her mission, goals and objectives. *Weaknesses* are negative internal factors that inhibit an individual's ability to accomplish his/her mission, goals and objectives. An entrepreneur should try to magnify his strengths and overcome or compensate for his/her weaknesses.

Opportunities are positive external options that an individual could exploit to accomplish his/her mission, goals and objectives. *Threats* are negative external forces that hinder an individual from accomplishing his/her mission, goals and objectives. These could arise due to competition, change in government policy, economic recession, technological advances etc. *Threats* in the environment can arise from competition, technological breakthroughs, change in government policies etc. S/he might possess certain unique skills or abilities, which along with his/ her knowledge and experience can provide him/ her cutting edge.

An analysis of the above can give the entrepreneur a more realistic perspective of the business, pointing out foundations on which s/he can build future strengths and remove obstacles. The hierarchical approach to the development of business idea is given below.

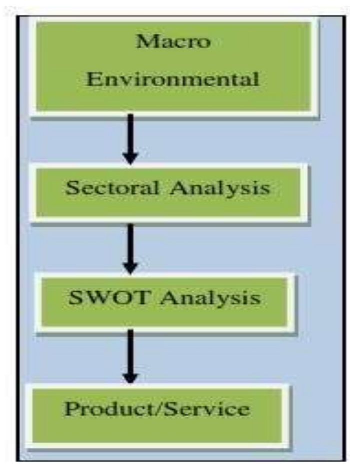


Figure 3.2 Hierarchical of Environmental Analyses

The entrepreneur has to use the opportunities provided by the environment, combine these with his/her unique strengths in terms of knowledge, skills, experience etc. and then take a decision to launch a particular product or service. The proposed product / service should be compatible with the capability of the entrepreneur, resources available in the environment and the need of the society.

7. Small Business Failure and Success Factors

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.

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 closes with a financial loss to a creditor.

Reasons for a termination abound. The owner may have an opportunity to sell her business to someone else for a healthy profit, or be ready to move on to a new business or to retire, or s/he may have simply lost interest in the business. The market for the business's product may have changed or become saturated. Perhaps the owner has decided it would be more appealing to work for someone else. In other cases, businesses may change form. A partnership may be restructured as a corporation, or a business may move to a new location. Businesses that undergo such changes are considered terminated even though they continue in another form.

Mistakes Leading to Business Failure

No one likes to think about failing, yet many small business owners invite failure by ignoring basic rules for success. One of the most common mistakes is to neglect to plan for the future because planning seems too hard or time-consuming. Planning what you want to do with your business, where you want it to go, and how you're going to get there are prerequisites for a sound business. Of course, that doesn't mean you can't change your plans as circumstances dictate. Your plan should provide a road map for your business, showing you both the expressways and the scenic routes and the detours.

Another common mistake is failing to understand the commitment and hard work that are required for turning a business into a success. Having to work long hours and do things you don't enjoy because no one else is available to do them are part and parcel of owning a small business. Yet, when you have the freedom of being your own boss, the hard work and long hours often don't seem so demanding!

Still another mistake that small business owners make, particularly with rapidly growing businesses, is not hiring additional employees soon enough or not using existing employees effectively. There comes a point in the growth of a business when it is no longer possible for the manager to do it all, but s/he resists delegation in the belief that it means s/he is giving up control. It is important to recognize that delegating tasks to others isn't giving up control—it's giving up the execution of details.

The last type of mistake involves with finances. Inaccurate estimates of cash flow and capital requirements can swamp a business quickly. Figuring the correct amount of money needed for starting a business is a tough balancing act: Asking for too little may hinder growth and actually jeopardize survival, whereas asking for too much might cause lenders or investors to hesitate. An important rule to remember in terms of arranging financing or calculating cash-flow projections is to figure the unexpected into your financial plans. In this way, you can have more of a cushion to fall back on if things don't go exactly according to plan. After all, without the right amount of capital, it's impossible to succeed.

Business failure, then, is a serious reality. How can a small business owner avoid it? Difficult changes may be needed, and change requires leaders to overcome all sorts of human dynamics, like inertia, tradition, and head-in-the-sand hoping that things will get better. Strategic moments require courage, or at least a lack of sentimentality, which is rare.

It is in these moments that the best leaders find a mirror and ask themselves the defining question that the late, great Peter drucker posed nearly 40 years ago: "If you weren't already in your business, would you enter it today?" If the answer is no, Drucker said, you need to face a second tough question: "What are you going to do about it?" Every leader should heed this good advice and, if need be, follow it through to its conclusion, whether that will be to fix, sell, or close the business.

Reflection: For instance, starting a business does involve risk, but the assumption of risk is part of life. An Economic consultant, David Birch, conducted his research on 2007 and found the divorce rate was 3.7 per 1,000. Of every 10,000 students who start college, about 52 percent fail to graduate. Would you decide not to get married because the divorce rate is too high? Were you afraid to go to college because of the dropout rate? The point to remember is that if you have a clear vision, know your product and your market, and devote the time and effort needed, your small business, like many others, can succeed.

3.7.2 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. For instance, John Deere relies on hundreds of vendors, many of which are small, to produce component parts for its farm equipment. Deere's extensive network of 3,400 independent dealers comprising small businesses provides sales and service for its equipment. These relationships enable Deere, the world's largest manufacturer of farm equipment, to focus on what it does best, while at the same time creating economic opportunity for hundreds of individual entrepreneurs.

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.

2. **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 smalbusiness 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.

3. **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.

8. Main Supporting Packages for MSEs Development in region

When entrepreneurs are deciding to involve and develop MSEs in region, 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 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.

9. Problems of Small Scale Business in region

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 regional 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. 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.

Small business's owner can avoid some of the common pitfalls that lead to business failure by knowing the business in depth; developing a solid business plan; managing financial resources; understanding financial statements; and learning to manage people effectively.

9. Organizational Structure and Entrepreneurial Team Formation

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.

2. Designing the Organization

Generally, the design of the initial organization will be simple. In fact, 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. In most cases when this occurs, the entrepreneur will have difficulty making the transition from a start-up to a growing, well-managed business that maintains its success over a long period of time.

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 organization. Effective interviewing and hiring procedures will need to be implemented to ensure that new employees will effectively grow and mature with the new venture.

All the design decisions involving personnel and their roles and responsibilities reflect the formal structure of the organization. In addition to this formal structure, there is an informal structure or organization culture that evolves over time that also needs to be addressed by the entrepreneur.

For many new ventures, predominantly part-time employees may be hired, raising important issues of commitment and loyalty. However, regardless of the number of actual personnel involved in running the venture, the organization must identify the major activities required to operate it effectively.

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. Typically, these expectations can be grouped into the following five areas:-

- *Organization structure*- This defines members' jobs and the communication and relationship these jobs have with each other. These relationships are depicted in an organization chart.
- *Planning, measurement, and evaluation schemes*- All organization activities should reflect the goals and objectives that underlie the venture's existence. The entrepreneur must spell out how these goals will be achieved (plans), how they will be measured, and how they will be evaluated.
- *Rewards*- Members of an organization will require rewards in the form of promotions, bonuses, praise, and so on. The entrepreneur or other key managers will need to be responsible for these rewards.
- *Selection criteria*- The entrepreneur will need to determine a set of guidelines for selecting individuals for each position.
- *Training*- Training, on or off the job, must be specified. This training may be in the form of formal education or learning skills.

In a nutshell, the organization's design can be very *simple*-that is, one in which the entrepreneur performs all the tasks (usually indicative of a start-up) -or *more complex*, in which other employees are hired to perform specific tasks. As the organization becomes larger and more complex, the preceding areas of expectation become more relevant and necessary.

As the organization evolves, the manager or entrepreneur's decision roles also become critical for an effective organization. As an entrepreneur, the manager's primary concern is to adapt to changes in the environment and seek new ideas. When a new idea is found, the entrepreneur will need to initiate development either under his or her own supervision or by delegating the responsibility to someone else in the organization. In addition to the role of adaptor, the manager will also need to respond to pressures such as an unsatisfied customer, a supplier reneging on a contract, or a key employee threatening to quit. Much of the entrepreneur's time in the start-up will be spent "putting out fires."

Another role for the entrepreneur is that of allocator of resources. The manager must decide who gets what. This involves the delegation of budgets and responsibilities. The allocation of resources can be a very complex and difficult process for the entrepreneur since one decision can significantly affect other decisions. The final decision role is that of negotiator. Negotiations of contracts, salaries, prices of raw materials, and so on are an integral part of the manager's job, and since he or she can be the only person with the appropriate authority, it is a necessary area of decision making.

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.

Some of the issues identified in the organization design will be revisited here since they are not only critical to the building of the team but are just as important in establishing a positive and successful organization culture.

This strategy must be maintained through the stages of start-up and growth of the enterprise. 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.

Although these functions may seem simple and easy to achieve, the people engaged and the culture promoted by the entrepreneur are critical in accomplishing these functions. As we underscored in the organization design section, the entrepreneur will first need to assume the responsibility of determining what skills and abilities are needed to meet the goals in the business plan. Not only are the skills and abilities important, but the entrepreneur also will need to consider the personality and character of each individual to create a viable organization culture.

The organization culture will be a blend of attitudes, behaviors, dress, and communication styles that make one business different from another. There is no specific technique for accomplishing this since every organization will be different. One thing that is important is that the entrepreneur(s) need to be able to delegate responsibility in order to create a vibrant organizational culture.

Let us explore some of the important considerations and strategies in recruiting and assembling an effective team and hence in creating an effective and positive organization culture.

- ***First***, the entrepreneur's desired culture must match the business strategy outlined in the business plan. It can be done by working with his/her staff to develop the Core Family Values that represent the key elements of the firm's culture and strategy. In other words, takes a hands-on approach to leadership but then steps away to let everyone make their own decisions regarding company strategy.
- ***Second***, the leader of the organization must create a workplace where employees are motivated and rewarded for good work.
- ***Third***, the entrepreneur should be flexible enough to try different things. This is not always possible in a very small organization but has been the successful strategy in the growth of Google. The leadership of this company has an abundance of talent, and the attitude of management is that this talent needs to be given enough flexibility to make decisions, as long as they do so within the model established by the company.
- ***Fourth***, it is necessary to spend extra time in the hiring process. There is sometimes a tendency to want to hurry the process of finding the appropriate skills to fill the organization's needs. As always happened, there is more to a person than his or her skills. Character is also an important factor in building an effective organization culture.

✓ ***Next***, the entrepreneur needs to understand the significance of leadership in the organization. Leadership should help establish core values and provide the appropriate tools so that employees can effectively complete their jobs.

✓ An approach such as, “We're all in this together, no one is bigger than anyone else, and here are the rules we live by,” can lead to greater challenges and job satisfaction.

✓ A reward system can play an important role in providing consistent and positive behavior patterns.

All in all, 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.

3.10 Course Summary

- ☞ Launching a new venture and becoming an entrepreneur is an exciting and challenging task. Can you learn how to be an entrepreneur or are some people just born that way? Some have argued that great entrepreneurs like Anita Roddick and Mohammed Yunis are simply born with different qualities to the rest of us – and it is these qualities that explain their success as entrepreneurs. But we know that a key human quality is the ability to change and develop over time. This is good news for anyone who wants to become an entrepreneur because it will require you to adapt and change with the enterprise you are founding as it develops and faces challenges. Becoming an entrepreneur is a never ending lesson as new challenges arise that offer experiences in how to do and not to do things.
- ☞ Small businesses include a wide variety of business types that are independently owned, operated, and financed. By itself, each individual small business has relatively little impact in its industry.
- ☞ Small businesses provided the economic foundation on which the country's economy was built. Today these businesses are creating new jobs even as large businesses continue eliminating jobs. Small businesses are more flexible than large ones in the products and services they offer. Most real product innovations come from small businesses.
- ☞ As the population becomes more diverse, the owners and employees of small businesses are likewise becoming more diverse. Businesses owned by women and minorities are growing at a faster rate than the overall rate of business growth. Diversity is important in small business because a wide range of viewpoints and personal backgrounds can improve problem solving.
- ☞ Small and large businesses need each other to survive—they have a symbiotic relationship. This relationship provides opportunities to small businesses in that they can supply needed parts to large manufacturers and can distribute manufactured goods. Moreover, small businesses often pick up functions that large businesses outsource. Other opportunities exist for small businesses where they enjoy the advantage of being able to profitably serve smaller niches than can their larger counter-parts. For all these reasons, small businesses are rapidly becoming important players in international trade.

- ☞ Ineffective and inefficient management, which shows up in many ways, is the number one cause of business failure. Inadequate financing, industry weakness, inexperience, and neglect are other major causes.
- ☞ To prevent your small business from becoming another casualty noted in business failure statistics, you must begin with a clearly defined competitive advantage. You must offer a product or service that people want and are willing to buy. You must do something substantially better than your competition does it. You must remain flexible and innovative, stay close to your customers, and strive for quality.
- ☞ 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 the era of entrepreneurship environment, not only are the skills and abilities important, but the entrepreneur also will need to consider the personality and character of each individual to create a viable organization culture.

3.12 Questions for Review and Discussions

1. How would you define small business?
2. Name a company that seems large but might be classified as small because it has relatively little impact on its industry.
3. Why are small businesses more likely than large businesses to be innovative?
4. How would you show that small business is becoming a more important part of the economy?
5. We compared the failure rate for small businesses with the divorce rate in marriage and the student failure rate in college. Are these fair comparisons?
6. Describe four causes of small business failure.
7. How does the quality of management relate to each of these causes?
8. Describe the techniques that a business with which you are familiar has used to prevent its failure.
9. Predict the future of small business. In what industries will it be most involved? What trends do you foresee? Will the failure rate go up or down? Will the importance of small business increase or decrease by the year 2030?