CHAPTER ONE
Entrepreneurship: An Overview

1.1 Definitions of the terms Entrepreneur and Entrepreneurship

Dear students, the starting point for any reading material on entrepreneurship must be the concept of entrepreneurship and entrepreneurs, and our understanding of them. What exactly is meant by the terms entrepreneurs and entrepreneurship? What is your understanding when the terms “entrepreneurs and entrepreneurship” are mentioned. Do you have any idea? The following section presents the definition of entrepreneurs and entrepreneurship in detail.

1.1.1 Definitions of an Entrepreneur

The term entrepreneur is defined in the variety of ways. Yet, no consensus has been arrived at on precise and universally accepted definition that states the skills and abilities that make a person a successful entrepreneur. The following are few of the definitions given by different authors:

- An Entrepreneur is an individual who, propelled by an idea, personal interest, goals, and ambition, brings together the financial and human resources, equipment, facilities to establish and manage a business enterprise (Donnely)
- An Entrepreneur is one who incubates new ideas, starts a business based on these ideas, and provides added value to the society on his/her independent initiative.(H. Molt)
- According to Schumpeter, entrepreneur is defined from two perspectives: developed and developing economics. The entrepreneur in an advanced economy is an individual who introduces something new in the economy. New in the economy can be a method of production not yet tested by experience, a product with which consumers are not yet familiar, a new source of raw material or a new market and the like. On the other hand, an entrepreneur in a developing economy is one who starts an industry (old or new), undertakes risk, bears uncertainties and also performs the managerial functions of decision making and coordination.
- An entrepreneur is an “energetic, single minded” person having mission and a clear vision he/she intends to create out this vision a business that produces and provides product or service that improves the lives of million. (David Silver)

1.1.2 Definitions of entrepreneurship

- Dr. C.B. Gupta defines entrepreneurship as the process of identifying opportunities in the market place, marshalling the resources required to pursue these opportunities and investing the resources to exploit the opportunities for long term lap gains. It involves creating wealth by bringing together resources in new ways to start and operate an enterprise.

- “Entrepreneurship is the process of creating something different with value by devoting the necessary time and effort assuming the accompanying financial psychic, and social

risks, and receiving the resulting rewards of monetary and personal satisfaction." (Hisrich)

- Entrepreneurship is the process of initiating a business venture, organizing the necessary resource and assuming the associated risks and rewards. (Daft)

- "Entrepreneurship is creating and building of value form practically nothing, that is, it is a process of creating or seizing an opportunity and pursuing it regardless of the sources currently controlled." (Timmos)

- Entrepreneurship is the process of identifying, developing, and bringing a vision to life. The vision may be an innovative idea, an opportunity, simply a better way to do something. The end result of this process is creation of a new venture, formed under conditions of risk and considerable uncertainty.

Furthermore the historical development of entrepreneurship shows the extent that the definition of an entrepreneur has evolved overtime as the world's economic structure has changed and becomes more complex. The following section explains the historical development of entrepreneurship.

1.2 A Historical Perspective of Entrepreneurship

The word "entrepreneur comes from the French verb enterpredre, which means "to undertake." Through the ages, the concept of entrepreneurship has shown a significant development and change in terms of scope.

In the early period an "entrepreneur" was a merchant adventurer who signs a contract with a money person to sell his goods. During that time, a common contract provided a loan to the merchant adventurer at a 22.5 percent rate. The merchant adventurer traveled great distances to find a market for the goods and played the active role in selling the goods.

During the middle age, the term entrepreneur was given to both an actor and a person who run large production projects. This individual did not take any risk but simply administered the project using the resource provided by the government of the country. The typical entrepreneur was the cleric who was responsible for the construction of great building such as castles and cathedrals. Also in the early 1600s, French man who organized and led military expeditions were called "Entrepreneur."

The concept of risk in the notion of entrepreneurship developed in the 17th century, with an entrepreneur being viewed as a person who entered a contractual arrangement with the government to perform a service or supply stipulated products. Since the contract price was fixed, any resulting profits or losses reflected the efforts of the entrepreneurs.

Finally, in the 18th century the person with capital was differentiated from one needing capital. In other words, the entrepreneurial role was distinguished from the capital providing role. The latter role is the basis for the present day venture capitalist. A venture capitalist is a professional money manager who invests in risky investments from a pool of equity capital to obtain a high rate of return on the investments (Ibid)

In the late 19th and early 20th centuries, entrepreneurs were frequently not distinguished from managers and were mainly viewed from economic perspective:

> *"Briefly stated, the entrepreneur organizes and operates an enterprise for personal gain. He pays current prices for the materials consumed in the business, for the use of land, for the personal services he employs, and for the capital he requires. He contributes his own initiative, skill and ingenuity in planning, organizing, and administrating the organization. He also assumes the chance of loss and gain consequent to unforeseen and uncontrollable circumstances. The net residue of the annual receipts of the enterprise after all costs have been paid, he retains for himself." (Hisrich, 1989:8)*

In the middle of the 20th century, the notion of an entrepreneur as an innovator was established:

> *"the function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an invention or, generally, an untried technological possibility for producing a new commodity or producing an old in a new way, opening a new source of supply of materials or a new out let for product, by reorganizing a new industry."*

The concept of innovation and newness as an integral part of entrepreneurship is at the heart of this definition. Indeed, innovation, the act of introducing something new, is one of the most difficult tasks for the entrepreneur. It takes not only the ability to create and conceptualize but also to understand all the forces at work in the environment. The newness can be anything from a new product to a new distribution system or to simply a new organizational structure. This ability to innovate is an instinct that distinguishes human beings from other creatures.

In almost all the definitions of entrepreneurship, there is agreement that basic elements such as : i) risk taking, ii) initiative taking, iii) organizing and reorganizing, iv) vision, and v) wealth creation are involved. And more than these the definition for the concepts entrepreneur and entrepreneurship include: a) decision making; b) using available resources in novel ways; c) action oriented; d) the ability to see business opportunities, the ability to gather resources to take advantage of them and the ability to take action; and e) the ability to search for change, respond to it, and exploit it.

Although there are many definitions of entrepreneur and entrepreneurship, no one of these definitions is complete to include all we know from experience. Some of the definitions may exclude those we feel from our experience about entrepreneurs and entrepreneurship and may include those we don't think are for entrepreneurs and entrepreneurship. Basically, entrepreneurship refers to what an entrepreneur does. The concepts of entrepreneur and entrepreneurship cannot be treaded separately. "The concepts of entrepreneur and entrepreneurship incorporate basic qualities of leadership, innovation, enterprise, hard work,

vision, risk taking and maximization of profit." (Vasant) These concepts have evolved over time as the world's economic structure has changed and become more complex.

To sum up, entrepreneur and entrepreneurship are two different but related terms. An entrepreneur is an individual who undertakes entrepreneurship activities (vasant)

1.3 The Myths of Entrepreneurship

Throughout the years many myths have arisen about entrepreneurship. These myths are the results of a lack of research on entrepreneurship. As many researchers in the field have noted, the study of entrepreneurship is still emerging, and thus "folklore" will tend to prevail until it is dispelled with contemporary research findings. Ten of the most notable myths with an explanation to dispel each myth appear next.

Myth 1: Entrepreneurs are Doers, Not Thinkers

> Although it is true entrepreneurs tend toward action, they are also thinkers. Indeed, they are often very methodical people who plan their moves carefully. The emphasis today on the creation of clear and complete business plans is an indication that "thinking" entrepreneurs are as important as "doing" entrepreneurs.

Myth 2: Entrepreneurs are Born, Not Made

> The idea that the characteristics of entrepreneurs cannot be taught or learned, that they are innate traits one must be born with, has long been prevalent. These traits include aggressiveness, initiative, drive, a willingness to take risks, analytical ability, and skill in human relations. Today, however, the recognition of entrepreneurship as a discipline is helping to dispel this myth. Like all disciplines, entrepreneurship has models, processes, and case studies that allow the topic to be studied and the knowledge to be acquired.

Myth 3: Entrepreneurs are Always Inventors

> The idea that entrepreneurs are inventors is a result of misunderstanding and tunnel vision. Although many inventors are also entrepreneurs, numerous entrepreneurs encompass all sorts of innovative activity. For example, Roy Kroc did not invent the fast-food franchise, but his innovative ideas made McDonald's the largest fast-food enterprise in the world. A contemporary understanding of entrepreneurship covers more than just invention. It requires a complete understanding of innovative behavior in all forms.

Myth 4: Entrepreneurs are Academic and Social Misfits

> The belief that entrepreneurs are academically and socially ineffective is a result of some business owners having started successful enterprise after dropping out of school or quitting a job. In many cases such an event has been blown out of proportion in an attempt to "profile" the typical entrepreneur. Historically, in fact, educational and social

organizations did not recognize the entrepreneur. They abandoned him or her as a misfit in a world of corporate giants. Business education, for example, was aimed primarily at the study of corporate activity. Today the entrepreneur is considered a hero – socially, economically, and academically. No longer is he or she a misfit, the entrepreneur is now viewed as a professional.

Myth 5: Entrepreneurs Must Fit the "Profile"

Many books and articles presented checklists of the characteristics of the successful entrepreneur. These lists were neither validated nor complete; they were based on case studies and on research findings among achievement-oriented people. Today we realize that a standard entrepreneurial profile is hard to compile. The environment, the venture itself, and the entrepreneur have interactive effects, which result in many different types of profiles. Contemporary studies conducted at universities across the United States will, in the future, provide more accurate insight into the various profiles of successful entrepreneurs.

Myth 6: All entrepreneurs Need is Money

It is true that a venture needs capita to survive; it is also true that a large number of business failures occur because of a lack of adequate financing. Yet having money is not the only bulwark against failure. Failure due to a lack of proper financing often is an indicator of other problems: managerial incompetence, lack of financial understanding, poor investments, poor planning, and the like. Many successful entrepreneurs have overcome the lack of money while establishing their ventures. To those entrepreneurs, money is a resource but never an end in itself.

Myth 7: All Entrepreneurs Need is Luck

Being at "the right place at the right time" is always an advantage. But "luck happen when preparation meets opportunity" is an equally appropriate adage. Prepared entrepreneurs who seize the opportunity when it arises often seem "lucky." They are, in fact, simply better prepared to deal with situations and turn them into success. What appears to be luck really is preparation, determination, desire, knowledge, and innovativeness.

Myth 8: Ignorance is Bliss for entrepreneurs

The myth that too much planning and evaluation lead to constant problems – that over analysis leads to paralysis – does not hold up in today's competitive markets, which demand detailed planning and preparation. Identifying a venture's strengths and weaknesses, setting up clear timetables with contingencies for handling problems, and minimizing these problems through careful strategy formulation are all key factors for successful entrepreneurship. Thus careful planning – not ignorance of it – is the mark of an accomplished entrepreneur.

Myth 9: Entrepreneurs Seek Success but Experience High failure Rates

> It is true that many entrepreneurs suffer a number of failures before they are successful. They follow the adage "If at first you do not succeed, try, try, and try again." In fact, failure can teach many lessons to those willing to learn and often leads to future successes. This is clearly shown by the corridor principle, which states that with every venture launched, new and unintended opportunities often arise.

Myth 10: Entrepreneurs are Extreme Risk Takers (Gamblers)

> The concept of risk is a major element in the entrepreneurial process. However, the public's perception of the risk most entrepreneurs assume is distorted. Although it may appear that an entrepreneur is "gambling" on a wild chance, the fact is the entrepreneur is usually working on a moderate or "calculated" risk. Most successful entrepreneurs work hard through planning and preparation to minimize the risk involved in order to better control the destiny of their vision.

These ten myths have been presented to provide a background for today's current thinking on entrepreneurship. By sidestepping the "folklore," we can build a foundation for critically researching the contemporary theories and processes of entrepreneurship.

1.4 The entrepreneurial process and challenges:

This part presents the activities involved in the entrepreneurial process and the main problems associated with the process.

1.4.1 The entrepreneurial process

The prospective entrepreneur, in order to establish and run a successful business, goes through a process known as the entrepreneurial process. During this process the entrepreneur carries out a number of activities that lead to the successful establishment and management of the business. The entrepreneurial process, which is made up of related activities, consists of the following phases.

1. Identifying and evaluating a business opportunity.
2. Developing the business plan.
3. Determining the resources required for the business and
4. Managing the resulting enterprise.

These activities overlap, meaning an activity will be started before the one that has already been started is completed. Therefore, the entrepreneur may need to consider the third or the fourth phase while still carrying out phase one. For instance, to evaluate the profitability of the business opportunity well, the entrepreneur needs the cost of the resources required to establish business.

i. Identifying and Evaluating the Business opportunity

This phase is the first and the most difficult since most business ideas do not suddenly appear. Generally a new business opportunity may be the result of a technological change, market shift,

government regulation, or competition. Good business opportunities are often the results of the entrepreneur being alert to the environment or extra effort in establishing opportunity identification mechanisms. Most entrepreneurs do not have formal mechanisms to identify new business opportunities. However, there are some sources such as consumers, members of distribution channels, and technical people that are generally fruitful. Often, the most and best business ideas come from customers. Complaints and remarks such as 'I wish there were a better product …' or 'I wish I could find a product that is specially made for …" may result in the inception of a new business idea and a new product.

Distribution channel members such as whole sellers, distributors and retailers are also good sources of business ideas. Their proximity to consumers of the product gives them the opportunity to better see a market gap or a demand for a better product. Technical people are also good sources of ideas for a new business. Technical people are also working on various projects, may come across a new or better way to manufacture a product. Regardless of its source, however, a newly generated business idea must be carefully examined. This evaluation of the business idea is perhaps the most critical of the entrepreneurial process, as it is the phase in which the profitability of the business idea will be determined.

The evaluation phase deals with the assessment of the opportunity for its length, its real and perceived value, its risks and returns, its differential advantage in its competitive environment, and its fit with the personal skills and goals of the entrepreneur. Here it is very important to note that the opportunity must also fit the personal interests of the entrepreneur, a person, without the necessary interest or skill to start a new venture, may not become a successful entrepreneur even if he or she has a brilliant business idea.

At this particular phase, as a matter of formal procedure, the entrepreneur may prepare an opportunity assessment plan. The plan, also referred to as opportunity analysis, focuses on the issues that enable the entrepreneur to make the decision whether to act on the opportunity or not. Focusing entirely on the opportunity, this plan includes a description of the product or service; an assessment of the entrepreneur, the team and the opportunity; specifications, of all the activities and resources needed to translate the opportunity into a viable business venture; and the sources of capital to finance the establishment of the venture as well as its growth.
The assessment of the opportunity is not an easy task, however. In fact, it is the most difficult and critical aspect of the opportunity analysis. Through the assessment analysis, the entrepreneur answers questions such as 'What market need does the product satisfy?', 'What resources from which sources will be required to convert the business opportunity in to a business venture?' 'Is the entrepreneur fit to act on the opportunity?', 'How fierce is the local and international competition?'

Remember that a business idea is not a business opportunity until it is assessed objectively and judged to be feasible. You may wish to choose one of the ideas that seem most promising for more detailed study. Trying to consider too many would make your focus on only one business idea, you are more likely to fall in love with it, and could lose your objectivity.

ii. Developing a Business Plan

Once a business idea is selected, the concept must be sharpened by an in depth planning process. The result of this step is a comprehensive business plan – the "blueprint" for the implementation process.

A business plan is a document the entrepreneur prepares before going to the implementation stage. It details every aspect of the business including the marketing, financial, organizational and operational plans. Developing the business plan is often difficult because the required resources for the plan may not be readily available and/ or the entrepreneur may not have rich experience in business plan preparation. This will be dealt in greater depth in chapter four.

iii. Determining the Required Resources

The entrepreneur needs to identify the resources required for the business before embarking on the business opportunity. The entrepreneur starts this phase with an assessment of the present resources. Then, carefully identifies all the resources required to get the business on its feet and run it successfully. Here, the entrepreneur must be careful not to understate the quality and quantity of the required resources. The entrepreneur also needs to classify the required resources in to two: the ones that are vital and the ones that are just helpful. It is also important to evaluate the impact of insufficient or inappropriate resources on the business. The next step will be to acquire the needed resources in the right quality and quantity on a timely basis. The resources needed may be finance, machinery, raw materials etc…

iv. Managing the Venture

Once the required resources for the business have been acquired, the entrepreneur will deploy them through the implementation of the business plan. At this stage, the entrepreneur examines the operational problems of the growing enterprise, a task that involves the implementation of an effective management approach and structure. An effective control mechanism also needs to be set up in order to identity and tackle emerging problems and challenges on time. Some entrepreneurs find managing and leading the venture they created very difficult – a distinction between entrepreneurs and managers.

1.4.2 Challenges of Entrepreneurial Process

Entrepreneurial problems are divided into two groups: **external** and **internal.** External problems are those which usually result from factors beyond the control of the entrepreneur like political, social, technological, and other related problems; while internal problems are those which are not influenced by external forces. The internal problems affecting entrepreneurs relate to organization, structure, production channel, distribution channel, technical know-how, training, industrial relations and inadequacy of management, etc. However, both kinds of problems are not mutually exclusive, they are co-related.

From the moment an entrepreneur conceives the idea to start his own business; he has to work against various problems. Some of the internal and external factors which hinder the development of entrepreneurship are:

1. **Management deficiency:** It could be said that management deficiency is one of the biggest reasons for poor performance of small scale units. The new entrants, in many cases did not have any prior training or background in management of their enterprises and were adverse to innovations and changes.

   In the beginning of business development, management problem may not be so critical but with growing sophistication and modernization of market requirements for the items produced by the small-scale sector, it has become very important for small entrepreneurs to employ modern methods of management be it in the field of advanced technology or marketing.

2. **Limited access to finance**: Financial inadequacy is one of the most inhibiting factors in the growth of entrepreneurship. The following are some of the limiting factors in accessing business finances:
   i) ***New is too risky*****:** Entrepreneurial businesses are generally viewed as risky investment due to their newness and smallness. Consequently, financial institutions resist providing loans for entrepreneurs.
   ii) ***No preferential interest rates:*** most entrepreneurs are unable to afford the high interest rates charged by banks and other financial institutions.
   iii) ***Longer loan processing time*****:** The processing time for loan applications by entrepreneurs tends to be long. The approval procedures are slow, often times leading to slower disbursements.
   iv) ***Lack of collateral demanded by lenders:*** Since the entrepreneurial activities are considered to be risky businesses, the collateral demanded by banks is often inhibiting. Usually the collateral demanded is higher than the value of the loan.

3. **Technological forces:** Technological forces are often the most abrupt and unpredictable part of an entrepreneurial environment. The knowledge behind a technological change may take several years to develop, but the impact of the breakthrough in to an actual product or a process makes it seem more like a revolution than evolution when the application of technology actually occurs.

4. **Limited access to market:** Another important factor in the development of entrepreneurship is the availability of market for the products offered. Entrepreneurs face overall limitations on penetrating and servicing their markets. The cost of penetrating the existed or the new market is relatively high for the newly developed business of an entrepreneur.

5. **Political factors:** A variety of forces can be at work in the political arena of an entrepreneurial environment. Entrepreneurs more and more must anticipate and adjust to changes in regulation, directives, and laws form various levels of government and governmental agencies.

The following table summarizes the various problems encountered by entrepreneurs:

Problems of Entrepreneurs	
A) Internal	**B) External**
1- Choice of an idea	1- Infrastructure
2- Feeble structure	i) Location
3- Faculty planning	ii) Power
4- Poor project implementation	iii) Water
5- Poor management	iv) Post office
6- Poor production	v) Communication
7- Poor quality	2- Financial
8- Marketing	i) Capital
9- Financial crunch	ii) Working capital
10- Labor problems	iii) Long term funds
11- Capacity utilization	iv) Recovery
12- Lack of vertical horizontal integration	3- Marketing
13- Inadequate training	4- Taxation
14- Poor and loose organization structure	5- Raw material
15- Lack of strategies	6- Industrial financial regulations
16- Lack of vision	7- Technology
17- Inadequate connections	8- Government policy
18- Lack of motivation	9- Competitive volatile environment
	10- Political environment

Source: Vasant Desal, (1999), Dynamics of entrepreneurial development and management.

Generally, the problems of entrepreneurs are multidimensional. These can be solved by the coordinated efforts of entrepreneurs, coordinated functioning of promotional agencies, and governmental assistance without red tape or bureaucratic delays. The entrepreneur has to be educated, and he/she should have a proper training in acquiring the necessary skill in running an enterprise within these various forces.

1.5 THE DARK SIDES OF ENTREPRENEURSHIP

A great deal of literature is devoted to extolling the rewards, successes, and achievements of entrepreneurs. However, a dark side of entrepreneurship also exists. This aspect of the entrepreneurial perspective has a destructive source that exists within the energetic drive of successful entrepreneurs. In examining this dual-edged approach to the entrepreneurial personality, experts have acknowledged the existence of certain negative factors that may envelop entrepreneurs and dominate their behavior. Although each of these factors possesses a positive aspect, it is important for entrepreneurs to understand the potential destructive vein of these factors.

It should be noted that “people who successfully innovate and start businesses come in all shape and size. But they do have a few things others do not. In the deepest sense, they are willing to

accept risk for what they believe in. They have the ability to cope with a professional life riddled by ambiguity, a consistent lack of clarity. Most have a drive to put their imprint on whatever they are creating. And while unbridle ego can be a destructive thing, try to find an entrepreneur whose ego is not wrapped up in the enterprise."

Entrepreneurs face a number of different types of risk. These can be grouped into four basic areas.

Financial risk: In most new ventures the individual puts a significant portion of his or her saving or other resources at stake. This money or these resources will, in all likelihood, be lost if the venture fails. The entrepreneur may be required to sign personally on company obligations that far exceed his or her personal net worth. The entrepreneur is thus exposed to personal bankruptcy. Many people are unwilling to risk their savings, house, property, and salary to start a new business.

Career risk: A question frequently raised by would-be entrepreneurs is whether they will be able to find a job or go back to their old job if their venture should fail. This is a major concern to managers who have a secure organizational job with a high salary and a good benefit package.

Family and social risk: Starting a new venture uses much of the entrepreneur's energy and time. Consequently, his or her other commitments may suffer. Entrepreneurs who are married, and especially those with children, expose their families to the risk of an incomplete family experience and the possibility of permanent emotional scars. In addition, old friends may vanish slowly because of missed get-togethers.

Psychic risk: The greatest risk may be to the well-being of the entrepreneur. Money can be replaced; a new house can be built; spouse, children, and friends can usually adapt. But some entrepreneurs who have suffered financial catastrophes have been unable to bounce back, at least not immediately. The psychological impact has proven to be too severe for them.

1.6 TYPES OF ENTREPRENEURSHIP

There are different kinds of entrepreneurs and entrepreneurship on the basis of the criteria used to classify entrepreneurs and entrepreneurship. The following are the most common criteria among others used for classifying entrepreneurs and entrepreneurship.

Source of capital

Based on the source of capital entrepreneurship can be divided into two as private and collective entrepreneurship. The first one is a form of entrepreneurship that is carried out by an individual on the basis of his or her own property. Collective entrepreneurship is carried out by two or more entrepreneurs on the bases of collective property, that is, capital contributed by the entrepreneurs.

Business idea generation

Entrepreneurship can be divided into three as – technological, geographical and sociological based on the business idea generation. A technological entrepreneur invents a new technology to

produce new products or new processes for producing old products. A geographical entrepreneur moves technology, the products and processes that goes with it from one place to another, usually from the developed world to the developing world. A sociological entrepreneur finds a new situation in which to sell an old product.

Reason for start up

Entrepreneurship can be classified into opportunity driven and necessity driven based on the drive that led the entrepreneur to start the business. Opportunity driven entrepreneur starts a company because he or she sees clear market opportunities to exploit. On the other hand the necessity driven entrepreneur goes into business to create self employment and his or her primary concern is survival. Generally, opportunity driven entrepreneurs are more growth oriented than necessity driven entrepreneurs.

1.7 THE ROLE OF ENTREPRENEURSHIP IN THE ECONOMY

The entrepreneur is the catalyst that plays a crucial role in developing a country's economy. Following are some contributions of the entrepreneur.

1. **Creation of Job Opportunities**

The hard work of the entrepreneur often results in the formation of a small business that opens job opportunities to many others in addition to the entrepreneur himself or herself. According to the US Small Business Administration, small businesses, many of which are entrepreneurial, comprise more than 99 percent of employers, employ 51 percent of all private – Sector workers and provide about 74 percent of new jobs in the USA.

2. **Better Production Methods and Products**

Entrepreneurs often introduce better production methods in terms of processing speed, quality of output, energy consumption, etc. Improved production methods in turn result in better goods and services. The improvement may be in terms of price, quality, location, ease of use, packaging, effectiveness of the product, etc.

3. **Identification of Business Opportunities and Markets**

Entrepreneurs always keep their eyes open to identify and exploit market opportunities. Once they identify an exploitable market opportunity, they devote themselves to satisfying the market gap. However, in real situation their act brings the opportunity for others to establish their own similar businesses and meet rest of the markets need.

4. **Conservation of Natural Resources.**

Some people became successful entrepreneurs because they managed to invent production methods that consumed less energy and raw materials. Such technologies result in the conservation of natural resources.

5. **Abolition of Monopoly and Enhancement of Competition**

Entrepreneurs often bring an end to monopolies that have existed for long. Such entrepreneurs discover the key knowledge or secrete technology that has endured a monopoly. Or they create alternative methods that can supply similar or substitute goods and services. Similarly, by supplying substitute goods and services, entrepreneurs foster keener competition in many markets, which naturally results in lower prices for consumers.

6. **Development of Complementary Goods Producers**

Complementary goods are products that are used together. Tea and sugar are good examples. For instance, the entrepreneur that establishes a local car manufacturing company that will sell its cars locally will indirectly contribute to the establishment of a number of local car repair shops.

7. **Increase in Per Capita Output and Income**

Entrepreneurial business activities result in increased income for the entrepreneur, his or her employees and other related businesses. The supply of goods and services in the economy will also be increase. This eventually leads to an increase in per capital output and income in the economy.

8. **Generation of Foreign Currency**

Entrepreneurs that are in the export business generate significant amount of foreign currency (dollar) to their home countries. This situation indirectly contributes to the development of the countries' economy by making more foreign currency available for increased volume of imports.

9. **Better Utilization of Resources**

Some entrepreneurs become successful by inventing methods and processes that enable the production of goods out of resource that have been ignored and labeled as "useless". Such initiative leads to improved use of neglected resources and conservation of the ones already in use.

10. **Improvement of Business Policies and Procedures**

Entrepreneurs create businesses that involve new transactions which do not fit into the existing business regulatory system and thus require the development of new business systems, laws, rules and policies. Such businesses instigate the revision of the existing business policies and procedures and lead to the development of new ones which ultimately result in better and safer business environment.

11. **Positive Externalities**

Externalities are the good (eg. New road constructed) or bad (e.g pollution) byproducts of a business which the nearby community will enjoy or be exposed to. The entrepreneur, while establishing his or her business, may develop infrastructure such as streets, electricity and water – wells that will be shared by the community as well.

12. Business Opportunity for Suppliers.

The entrepreneur needs to acquire inputs such as employees and raw materials to produce goods and services. In most cases the entrepreneur will not be able to supply these inputs for the business on his or her own. Therefore, these resources have to be supplied by other businesses, a situation that results in a business opportunity for suppliers.

1.8 INNOVATION AND ENTREPRENEURSHIP

Innovation is a key function in the entrepreneurial process. Most researchers and authors in the field of entrepreneurship are, for the most part, in agreement with Drucker about the concept of innovation:

> *Innovation is the specific function of entrepreneurship .... It is a means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth.*

Innovation is the process by which entrepreneurs convert opportunities into marketable ideas. It is a means by which they become catalyst for change. It is important to recognize the role of creativity in the innovative process. **Creativity** is the generation of ideas that result in the improved efficiency or effectiveness of a system. Two important aspects of creativity exist: process and people. The process is goal-oriented; it is designed to attain a solution to a problem. The people are the resources that determine the solution. The process remains the same, but the approach that the people use will vary.

The Nature of the Creative Process

Creativity is a process that can be developed and improved. Everyone is creative to some degree. However, as is the case with many abilities and talents, some individuals have a great aptitude for creativity than others. Also, some people have been raised and educated in an environment that encouraged them to develop their creativity. They have been taught to think and act creatively. For others the process is more difficult because they have not been positively reinforced, and, if they are not creative, they must learn how to implement the creative process.

The creative process has five commonly agreed-on phases or steps. Most experts agree on the general nature and relationship among these phases, although they refer to them by a variety of names. Experts also agree that these phases do not always occur in the same order for every creative activity. For creativity to occur, chaos is necessary but a structured and focused chaos. We shall examine this five-step process using the most typical structural development.

Phase 1: Idea Germination

The germination stage is a seeding process. It is not like planting seed as farmer does to grow crown, but more like the natural seeding that occurs when pollinated flower seeds, scattered by the wind, find fertile ground to take root. Exactly how an idea is germinated is a mystery; it is not something that can be examined under a microscope. However, most creative ideas can be traced to an individual's interest in or curiosity about a specific problem or area of study.

Phase 2: Preparation

Once a seed of curiosity has been taken from as a focused idea, creative people embark on a conscious search for answer. If it is a problem they are trying to solve then they begin an intellectual journey, seeking information about a problem and how others have tried to resolve it. If it is an idea for a new product or service, the business equivalent is market research. Inventors will set up laboratory experiments, design will begin engineering new product ideas, and marketers will study consumers buying habits. Any individual with an idea will consequently think about it, concentrating his or her energies on rational extensions of the idea and how it might become a reality. In rare instances, the preparation stage will produce result. More often, conscious and deliberate will only overload the mind, but the effort is important in order to gather knowledge vital to an eventual solution.

Phase 3: Incubation

Incubation is a stage of "mulling it over" while the subconscious intellect assumes control of the creative process. This is a crucial aspect of creativity because when we consciously focus on a problem, we behave rationally to attempt to find systematic resolutions. When we rely on subconscious processes, our minds are untrammeled by limitations of human logic. The subconscious mind is allowed to wander and to pursue fantasies, and it is therefore open to unusual information and knowledge that we cannot assimilate in a conscious state. This subconscious process has been called the art of synectics, means a joining together of different and often unrelated ideas. Therefore, when a person has consciously worked to resolve a problem without success, allowing it to incubate in the subconscious will often lead to a resolution.

Phase 4: Illumination

The fourth stage, illumination, occurs when the idea resurfaces as a realistic creation. The important point is that most creative people go through many cycles of preparation and incubation, searching for that incident as a catalyst to give their idea full meaning. When a cycle of creative behavior does not result in a catalytic event, the cycle is repeated until the idea blossoms or dies. This stage is critical for entrepreneurs because ideas, by themselves, have little meaning. Reaching the illumination stage separates day dreamers and tinkerers from creative people who find a way to transmute value.

Phase 5: Verification

An idea once illuminated in the mind of an individual still has little meaning until verified as realistic and useful. Entrepreneurial effort is essential to translate an illuminated idea into a verified, realistic, and useful application. Verification is the development stage of refining knowledge into application. This is often tedious and requires perseverance by an individual committed to finding a way to "harvest" the practical result of his or her creation. During this stage, many ideas fall by the wayside as they prove to be impossible or to have little value. More often, a good idea has already been developed, or the aspiring entrepreneur finds that competitors already exist. Inventors quite often come to this harsh conclusion when they seek to patent their products only to discover similar inventions registered.

THE INNOVATION PROCESS

Most innovations result from a conscious, purposeful search for new opportunities. This process begins with the analysis of the sources of new opportunities. Drucker has noted that because innovation is both conceptual and perceptual, would-be innovators must go out and look, ask, and listen. Successful innovators use both the right and left sides of their brains. They look at figures. They look at people. They analytically work out what the innovation has to be to satisfy the opportunity. Then they go out and look at potential product users to study their expectations, values, and needs.

Most successful innovations are simple and focused. They are directed toward a specific, clear, and carefully designed application. In the process they create new customers and new markets. Above all, innovation often involves more work than genius. As Thomas Edison once said, "Genius is 1 percent inspiration and 99 percent perspiration." Moreover, innovators rarely work in more than one area. For all his systematic innovative accomplishment, Edison worked only in the electricity field.

Type of Innovation

Four basic types of innovation exist. These extend from the totally new to modifications of existing products or services. In order of originality, the following are the four types:

- **Invention:** The creation of a new product, service, or process, often one that is novel or untried. Such concepts tend to be "revolutionary."
- **Extension:** the expansion of the product, service or process already in existence. Such concepts make different applications of current idea.
- **Duplication:** The replication of an already existing product, service, or process. The duplication effort, however, is not simply copying but adding the entrepreneur's own creative touch to enhance or improve the concept to beat the competition.
- **Synthesis:** the combination of existing concepts and factors into a new formulation. This involves taking a number of ideas or items already invented and finding a way so that together they form a new application.

Sources of Innovation

Innovation is a tool by which entrepreneurs typically exploit change rather than create change. Although some inventions have created change, these are rare. It is more common to find

innovations that take advantage of change. The internal and external areas that serve as innovation sources are presented next.

Unexpected Occurrences: These are successes or failures that, because they were unanticipated or unplanned, often end up proving to be a major innovative surprise to the firm.

Incongruities: These occur whenever a gap or difference exists between expectation and reality. For example, when Fred Smith proposed overnight mail delivery, he was told, "If it were that profitable, the U.S. post office would be doing it." It turned out Smith was right. An incongruity existed between what Smith felt was needed and the way business was currently conducted.

Process need: These exist whenever a demand arises for the entrepreneur to innovate and answer a particular need. The creation of health foods and time-saving devices are examples.

Industry and Market Changes: Continual shifts in the marketplace occur, caused by development such as consumer attitudes, advancement in technology, industry growth, and the like. Industries and markets are always undergoing changes in structure, design, or definition. An example is found in the health care industry, where hospital care has undergone radical change and where home health care and preventive medicine have replaced hospitalization and surgery as a primarily focus area. The entrepreneur needs to be aware of and seize these emerging opportunities.

Demographic Change: These arise from trend changes in population, age, education, occupations, geographic locations, and similar factors. Demographic shifts are important and often provide new entrepreneurial opportunities. For example, as the average population of Ethiopia has increased, land development, recreational, and health care industries all have profited.

Perceptual Changes: These changes occur in people's interpretation of facts and concepts. They are intangible yet meaningful. Perception can cause major shifts in ideas to take place. The current fitness craze, caused by the perceived need to be healthy and physically fit, has created a demand for both health foods and health facilities.

Knowledge-Based Concepts: These are the basis for the creation or development of something brand new, trying into our earlier discussion of invention as a type of innovation. Inventions are knowledge-based; they are the product of new thinking, new methods, and new knowledge. Such innovations often require the longest time period between initiation and market implementation because of the need for testing and modification.

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Major Innovation Myths

Presented next is a list of the commonly accepted innovation myths, along with reasons why these are myths and not facts.

Myth 1: Innovation is fact and predictable: This myth is based on the old concept that innovation should be left to the research and development department under a planned format. In truth, innovation is unpredictable that may be introduced by anyone.

Myth 2: Technical specifications should be thoroughly prepared: Thorough preparation often takes too long. Quite often it is more important to use a try/test/revise approach.

Myth 3: Creativity relies on dreams and blue-sky ideas: Accomplished innovators are very practical people and create from the opportunities left by reality- not daydream.

Myth 4: Big projects will develop better innovations than smaller ones: This myth has been proved false time and time again. Larger firms are now encouraging their people to work in smaller group, where it is often easier to generate creative ideas.

Myth 5: Technology is the driving force of innovation: Technology is certainly one source for innovation, but it is not the only one. Moreover, the customer or market is the driving force behind any innovation. Market-driven or consumer-based innovations have the highest probability of success.

Principles of Innovation

Potential entrepreneurs need to realize that innovation principles exist. These principles can be learned and, when combined with opportunity, can enable individuals to innovate. The following are the major innovation principles:

- Be action oriented: Innovators always must be active and searching for new ideas, opportunities, or sources of innovation.
- Make the product, process, or service simple and understandable: People must readily understand how the innovation works.
- Make the product, process, or service customer-based: Innovators always must keep the customer in mind. The more an innovator has the end user in mind, the greater the chance the concept will be accepted and used.
- Start small: Innovators should not attempt a project or development on a grandiose scale. They should begin small and then build and develop, allowing for planned growth and proper expansion in the right manner and at the right time.
- Aim high: Innovators should aim high for success by seeking a niche in the marketplace.
- Try/test/revise: Innovators always should follow the rule of try, test, and revise. This helps work out any flaws in the product, process, or service.

- Learn from failures: Innovation does not guarantee success. More important, failures often give rise to innovations.
- Follow a milestone schedule: Every innovator should follow a schedule that indicates milestone accomplishments. Although the project may run ahead or behind schedule, it still is important to have the schedule in order to plan and evaluate the project.
- Work, work, work: This is a simple but accurate exhortation with which to conclude the innovation principles. It takes work – not genius or mystery – to innovate successfully.

Chapter Two

Entrepreneurial Background, Trait and Motivation

2.1 THE ENTREPRENEURIAL BACKGROUND

All entrepreneurs are not the same. Different entrepreneurs have different cultural and educational background, family structures and situations. They come from a variety of professions, age groups and nationalities. An entrepreneur can be a male or a female, a young man or an old woman, a nurse or an engineer. Therefore, there is no such thing as a 'true entrepreneurial profile'. Even though research has explored many aspects of entrepreneurs' background; it has discovered only a few areas that differentiate the entrepreneur from the average person. The entrepreneur's background areas investigated include childhood family environment, education, personal values, age, and work history.

Childhood Family Environment

There are some hypotheses that hold being a firstborn or an only child to a family contributes to the child's receiving special attention and to the child's development of more self- confidence. One study found that out of the 408 female entrepreneurs surveyed, 50% were found to be firstborn. However, there is no clear evidence that establishes this hypothesis.
Another related area in which research probed in to was the occupation of the entrepreneur's parents. Evidence strongly suggests that entrepreneurs tend to have self- employed or entrepreneurial father. Having a self – employed parent provides a strong inspiration for the entrepreneur. The independence and flexibility gained by the parent through self- employment is ingrained at an early stage. The knowledge that will be shared from such an experienced family member is also very important for the entrepreneur's success. Parents of entrepreneurs, whether they are entrepreneurs or not, must be supportive. They need to encourage responsibility, achievement and independence through self-employment order to establish the interest of entrepreneurship in their children.

Generally, the support parents give, especially that of the father, appears to be the most important for female entrepreneurs. Female entrepreneurs tend to posses similar personality as their fathers and come from middle to upper- class environments where families are likely to be child centered.

Education

Some people feel that entrepreneurs are less educated than the average non- entrepreneur. However, research proves otherwise. In fact, most entrepreneurs were found to have at least a college degree. Education was important in the entrepreneur's upbringing. It has also been found to play a vital role in helping the entrepreneur deal with daily challenges.

Even though education is not a precondition to start up a business, it makes the entrepreneur's life easier in establishing and running the venture, especially, if it is related to the entrepreneur's

engagement. Commonly, it is to the entrepreneur's benefit to have some education in the areas of finance, strategic planning, marketing, human resource management and communication.

Age

Most entrepreneurs launch their entrepreneurial careers between the age of 22 and 45. Why? What makes this age range special? Well, it is true that entrepreneurs aging out of the above range may emerge. However, this is often very unlikely, as the entrepreneur needs experience, financial backing, courage and energy to start up and run a new business.

Research shows that there appears to be patterns of ages, specifically 25, 30, 35, 40, 45, 50, and 55 at which individuals are more inclined to emerge as entrepreneur. Generally, male entrepreneurs launch their first significant venture in the early 30s, while female entrepreneurs tend to do so in their middle and late 30s.

Work Experience

Work experience not only positively impacts a person's decision to start an entrepreneurial career but contributes significantly to the person's struggle to lead the new venture to success. Commonly lack of challenge and promotional opportunism, frustration and boredom with one's job encourage people to start up their own businesses. In any case, previous knowledge and experience are important to launch the new business. Particularly exposure to the areas of finance, product development, manufacturing, development of distribution channels and marketing is advantageous. As the business increases in size, the business activities become more complex and diverse, a situation that makes managerial and entrepreneurial experiences and skills increasingly important.

Sex structure

Even though there has been significant growth in female self employment, men make up the majority of people who start and own their own businesses. While very similar in overall characteristics, women entrepreneurs possess very different motivations and occupational backgrounds than their male counterparts. Factors in the startup process for business of male entrepreneurs are different to that of females especially in such areas as source of funds, support systems, business skill levels, and personality.

- Men are often motivated by the derives to control their own destinies. This derives often stems from disagreements with their bosses or feelings that they run things better. In contrast, women tend to be more motivated by independence and achievement arising from job frustration. The reason for transition from the past occupation to the new venture for men is often facilitated when the new venture is an outgrowth of a present job, sideline, or hobby. Women, on the other hand, often leave a previous job with a high level of job frustration and enthusiasm for the new venture.
- The background of male and female entrepreneurs tends to be similar, except that most women are a little older when they start their venture and their educational backgrounds are different. Men often have studied in technical or business related areas, while most women have a liberal arts education.
- While males often get finance from investors, bank loans, personal loans, or personal funds as a startup capital, women usually rely solely on personal asset or savings.
- In terms of support group men usually have outside advisors as more important supporters with the spouse being the second. Women on the other hand consider their

spouse first, close friends second, business associations, trade associations, and women groups third. They usually rely heavily on a variety of sources for support and information.

- Although both groups tend to have experience in the fields of their venture, men have attained competence in a variety of business skills. Men have experience in manufacturing finance, construction, and high technical areas. In contrast, most women entrepreneurs usually have administrative experience that is limited to middle level management. They usually work-in service related areas such as education, secretarial work, retail sales, public relations, etc.
- In terms of personality, there are strong similarities between male and female entrepreneurs. Both tend to be energetic, goal oriented, and independent. However, men are often more confident, less flexible, and more tolerant than women.

2.2 ENTREPRENEURIAL TRAITS

Probably no other aspect of entrepreneurship has been studied more than the traits and characteristics that make up the entrepreneurial personality. A number of studies have been conducted to determine whether entrepreneurs distinctly differ from managers and the public at large in personality and other characteristics. Studies have found that while entrepreneurs have various characteristics that contribute to success only few make them different from managers and the general populace.

As most argue, some of the characteristics which are commonly exhibited by successful entrepreneurs are:

- **Need for Achievement**

Psychologists recognize that people differ in their need for achievement. Individuals with a low need for achievement are those who seem to be contented with their present status. On the other hand, individuals with a high need for achievement like to compete with some standard of excellence and prefer to be personally responsible for their own assigned tasks, i.e., need achievement a desire to succeed, where success is measured against a personal standard of excellence.

According to Slavin, need for achievement is the desire to experience success and to participate in activities in which success is dependent on personal effort and abilities. It is a generalized tendency to strive for success and to choose goal – oriented success / failure activities"

David C. McClelland is a leader in the study of achievement motivation. According to him, people with high achievement motivation have the desire to do well, work harder at certain tasks, tend to learn faster, do their best work when it counts for the record and not for inventive or profits, choose experts over friends as working partners, like accurate knowledge of activities (feedback), are responsive and make use of opportunities, and have the urge to improve and do well.

Entrepreneurs tend to set themselves clear and demanding goals. They benchmark their achievements against these personal goals. As the result, entrepreneurs tend to work to internal standards rather than look to others for assessment of their performance. They set themselves goals and targets, are self motivated and take pleasure in achieving these goals.

"McClelland has discovered a positive correlation between the need for achievement and entrepreneurial activity." Hence, according to him, those who become entrepreneurs have, on the average, a higher need for achievement than do members of the general population.

- **Risk Taking**

Virtually all recent definitions of an entrepreneur indicate a risk – taking component. Indeed, risk whether financial, social, or psychological, is a part of the entrepreneurial process. "While entrepreneurs are often known as risk takers, they seem to be careful to take only calculated risks."

The idea that entrepreneurs are risk – takers is one which reflects their popular image. However we must be very careful to distinguish between personal risk and economic risk. We may face personal risk by exposing ourselves to dangerous situations. But to an economist, risk results from making an investment. Risk is the possibility that the return from an investment may be less than expected, or, to be exact, might be less than could have been obtained from an alternative investment that was available. So, acceptance of risk is something that investors do, not entrepreneurs as such. However, the popular impression that the entrepreneur is a risk-taker is not completely inappropriate. It recognizes that entrepreneurs are good at managing in situations where risk is high; that is, when failed with a situation of high uncertainty they are able to keep their head, to continue to communicate effectively and to carry on making effective decisions.

The extent to which entrepreneurs have a distinctive risk taking propensity is still debatable. Some studies, for example, have found entrepreneurs to be similar to professional managers, while other studies found them to have a greater willingness to assume risk. And even some studies found entrepreneurs scored lower on risk taking than investor. This debate, however, does not obscure the fact that entrepreneurs must be willing to assume various risks. They typically place a great deal on the line when they choose to enter to business for themselves.

Running own business is risky. The entrepreneur assumes all possible risks of business which emerge due to the possibility of changes in tastes of consumers, techniques of production and new inventions, political and economical changes. If they materialize, the entrepreneur has to bear the loss himself. Thus, risk bearing still remains as the most important characteristic of an entrepreneur which he /she tries to reduce by his / her initiative, skill and good judgment.

- **Hard Working**

Entrepreneurs put a lot of physical and mental effort in to developing their ventures. They often work long and anti social hours. After all an entrepreneur is their own most valuable asset. Balancing the needs of the venture with other life commitment such as family and friends is one of the great challenges of entrepreneurs but they manage it by putting a lot of efforts.

Running a business allows entrepreneurs to stay for longer hours in their business. The success of an entrepreneur demands the ability to work long hours for sustained periods of time.

- **Innovation**

Innovation lies at the heart of entrepreneurship. Yet to believe in innovation we have to see the world in a certain sort of way. We have to believe in a future that will be different from the present. We have to believe that we can act to influence the world and change it by our actions. Further, if we are to be encouraged to innovate, we must believe that it is appropriate that we are rewarded for our efforts in developing innovation.

The successful entrepreneurial venture is usually based on a significant innovation. This might be a technological innovation, it might be an innovation in offering a new service, an innovation in the way something is marketed or distributed, or possibly an innovation in the way the organization is structured and managed, or in the way relationships are maintained between organizations.

Innovation is the specific tool of entrepreneurs, the means by which they exploit change as an opportunity for different businesses or different services. It is capable of being presented as a discipline, capable of being learned and practiced. Entrepreneurs need to search purposefully for the sources of innovation, the changes and their symptoms that indicate opportunities for successful innovation.

Entrepreneurs see changes as the norm and as healthy. Usually they may not bring the change themselves. But entrepreneurs always search for change, respond to it, and exploit it as an opportunity.

- **Self Confidence**

Individuals who possess self-confidence feel they can meet the challenges that confront them. They have a sense mastery over the types of problems they might encounter. Studies show that successful entrepreneurs tend to be self reliant individuals who see the problem in launching a new venture but believe in their own ability to overcome problems.

The entrepreneur must demonstrate that they not only believe in themselves but also in the venture they are pursuing.

People who start and run a business must act decisively. They need confidence about their ability to master the day – to – day tasks of the business. They must feel sure about their ability to win customers, handle the technical details, and keep the business moving. Entrepreneurs also have a general feeling of confidence that they can deal with anything in the future; complex, unanticipated problems can be handled as they arise.

- **Locus of Control**

  The task of starting and running a new business requires the belief that you can make things come out the way you want. The entrepreneur not only has a vision but also must be able to plan to achieve that vision and believe it will happen. Most entrepreneurs have an internal locus of control, that is, they feel they have control over events that affect their success. They can use initiative and drive to create opportunities and exploit them.

  An internal locus of control is a belief by individuals that their future is within their control and that other external forces will have little influence. For entrepreneurs, reaching the future is seen as being in the hands of the individual. Many people, however, feel that the world is highly uncertain and that they are unable to make things come out the way they want. An external locus of control is the belief by individuals that their future is not within their control but rather is influenced by external forces.

  While internal locus of control appears to differentiate entrepreneurs from the general public, they may not differentiate entrepreneurs from mangers.

- **Good health**
  Successful entrepreneurs are generally physically resilient and in good health. When they get sick, they recover quickly, in small businesses, where there is no depth of management, the leader must be always there. Especially in the beginning, the entrepreneur may not afford to hire a support staff to cover all business function. Therefore he or she needs to work long hours, and for that he or she needs to be healthy.

- **Persona Values**

  Many studies indicate that personal values are important for the entrepreneur. However, they often fail to indicate that entrepreneurs are different form managers or any other person, as far as these values are concerned. For instance, both a manager and an entrepreneur may be creative. But still personal values such as aggression, benevolence, conformity, creativity, resource seeking and ethics are very important for the entrepreneur. Studies have shown that entrepreneur's attitude towards the nature of the management process and the business in general differs. Hirsch and Peters write 'The nature of the enterprise, opportunism, institution, and individuality of the entrepreneurs diverge significantly from the bureaucratic organization and the planning, rationality and predictability of its managers.

- **Sense of urgency**
  Entrepreneurs have a never – ending sense of urgency to develop their ideas. Inactivity makes them impatient, tense and uneasy. They normally prefer individual sports such as golf, skiing, or tennis over tea sports. They prefer games in which their own effort directly influences the outcome and pace of game. They have drive and high energy levels.
- **Comprehensive Awareness**
  Successful entrepreneurs can comprehend complex situations that may include planning, strategic decision making, and working on multiple business ideas simultaneously, they are farsighted and aware of important details, and they continuously review all possibilities to achieve their business objectives.
- **Realism**
  Entrepreneurs accept things as they deal with them accordingly. They may or may not be idealistic, but they are rarely unrealistic. They will change their direction when they see that change will improve their prospects for achieving their goals.
- **Conceptual Ability**
  Entrepreneurs possess the ability to identify relationships quickly, even in complex situation. They identify problems and begin working on their solution faster than other people do. Entrepreneurs are natural leaders and are usually the first to identify a problem. If it is pointed out to them that their solution to a problem will not work for some valid reason, they will quickly identify an alternative approach.

Table 2.1 Characteristics Often Attributed to Entrepreneurs

1. Confidence	21. Perseverance, Determination
2. Energy, diligence	22. Responsibility
3. Resourcefulness	23. Foresight
4. Ability to take calculated risk	24. Accuracy, thoroughness
5. Dynamism, leadership	25. Cooperativeness
6. Optimism	26. Profit orientation
7. Need to achieve	27. Ability to learn from mistakes
8. Versatility	28. Sense of power
9. Creativity	29. Pleasant personality
10. Ability to influence others	30. Egotism
11. Ability to get along well with people	31. Courage
12. Initiative	32. Imagination
13. Flexibility	33. Perceptiveness
14. Intelligence	34. Toleration to ambiguity
15. Orientation to clear goals	35. Aggressiveness
16. Positive response to challenges	36. Capacity for enjoyment
17. Independence	37. Efficacy
18. Responsiveness to suggestion and criticism	38. Commitment
19. Time competence, efficiency	39. Ability to trust workers
20. Ability to make decision quickly	40. Maturity, balance

Source: John A. Hornaday, "Research about living entrepreneurs," 1982, 26-27

- **Status Requirements**
  Entrepreneurs find satisfaction in symbols of success that are external to themselves. They like the business they have built, not themselves, to be praised. Symbols of achievement such as position have little importance to them. Successful entrepreneurs find their satisfaction of status needs in the performance of their business, not in the appearance they present to the public. They postpone acquiring status items like a luxury car until they are certain that their business is stable. Their personalities do not prevent them from seeking facts, date and guidance. When they need help, they will not hesitate to admit.

- **Interpersonal Relationships**
  The average entrepreneur is more concerned with people's achievements than with their feelings. Entrepreneurs generally avoid becoming personally involved and will not hesitate to sever relationships that could hinder the progress of their businesses. During the business- building period, when resources are scarce, they seldom devote time to dealing with satisfying people's feelings beyond what is essential to achieving their goals. As the business grows and assumes an organizational structure, the entrepreneurs' need for control makes it difficult for them to delegate authority in the way that a structured organization demands. Their strong direct approach induces them to seek information directly from its source, by passing the structured chains of authority and responsibility. Their moderate interpersonal skills, which are adequate during the start – up phases, will cause them problems as they try to adjust to the structured or corporate organization.
- **Emotional Stability**
  Entrepreneurs have a considerable amount of self- control and can handle business pressures. They are comfortable in stress situations and are challenged rather than discouraged by failures. Entrepreneurs are uncomfortable when things are going well. They will frequently find some new activity on which to vent their pent-up energy.

Table 2.2 Twenty-First Centaury Characteristics of Entrepreneurs

The Top Ten Characteristics Today's Entrepreneurs Share

- **Recognize and take advantage of opportunities**
- **Resourceful**
- **Creative**
- **Visionary**
- **Independent thinker**
- **Hard worker**
- **Optimistic**
- **Innovator**
- **Risk taker**
- **Leader**

Source: Soo Ji Min, "Made not born," Entrepreneur of the year Magazine (fall 1999): 80.

- **Attraction to challenges and Competition.**
  Entrepreneurs are attracted to challenges and competition by nature. Many were active in sports and other competitions in high school and college. Others were competitive in wanting to make good grades, earn the respect of their parents and achieve their goals.

- **Money management**

Entrepreneurs are careful about money. They always know how much money they have. They know the value and cost of things and thus they can recognize a real bargain. Most entrepreneurs earned money when they were teenagers-babysitting, mowing lawns, delivering newspapers, sacking groceries, etc..

- **Loners:** Entrepreneurs are usually loners rather than team players. They prefer a solitary work environment.

- **Leisure Time:** Entrepreneurs do set aside time for leisure activities and family. But their principal form of relaxation is their work.

- **Self- Esteem:** Entrepreneurs have a high sense of one's own self-worth. Without that, individuals will never undertake tough challenges.

- **Screening for opportunity:** Entrepreneurs screen incoming information in a different way since they constantly seek new growth opportunities. They are like gold miners who shift through tons of dirt to spot new market opportunities.

- **Goal orientation:** Entrepreneurs have a relentless drive to accomplish goals. They understand what their priorities are and continue to work hard towards those goals. Staying focused on a goal, however, is a very difficult thing to do, since life in the world of business ends to distract us.

- **Optimism:** Underlying successful entrepreneurial leadership is a boundless optimism that never seems to end. For entrepreneurs, a problem is simply a challenge. When faced with an obstacle, they take it as a new direction, when told no, they say, "Maybe not now, but I know you'll change your mind soon."

- **Courage:** Building a company form the ground up requires a great deal of courage. Someone once said that large organizations function like "Womb" protecting employees form a harsh and merciless environment to take a great deal of courage to leave a corporate or government womb and join the cold, cruel would of business where one will find him or herself all alone.

- **Tolerance to Ambiguity:** Entrepreneurs are not bothered by ambiguity and uncertainty. They can clearly and comfortably see the fact and the relationship of things in a very complicated situation or problem.

2.3 ENTREPRENEURIAL MOTIVATION

What motivates an entrepreneur to take all the risks and launch a new venture, pursuing an entrepreneurial career against the overwhelming odds for success? Although many people are interested in starting a new venture and even have the background and financial resources to do so, few decide to actually start their own business.

Given the sizable risks, time and energy requirements of entrepreneurship, why do so many individuals take the entrepreneurial plunge every year? Entrepreneurs are motivated to launch business for a number of reasons. While the motivations for venturing out alone vary greatly, they can be grouped in to two broad categories: pull factors and push factors.

Pull Factors

Some individuals are attracted towards small business ownership by positive motive such as a specific idea which they are convinced to work on. Pull factors are those which encourage individuals to become entrepreneurs by virtue of the attractiveness of the entrepreneurial option. Some important pull factors are the following:

Independence: "Being my own boss" is a powerful motivator for many entrepreneurs, who seek the freedom to act independently in their work. As heads of business, they enjoy the autonomy of making their own decisions, setting their own work hours, and determining what they will do and when they will do it.

Need for independence has been suggested as a fundamental motivation of small business owners. Entrepreneurs prefer to be their own boss, have often escaped from what they perceived to be hierarchical regimes of the large corporation and to have realized a sense of purpose through owning and managing their own business.

The need for power or control: The need for power has also been suggested as a source of motivation. Power has been defined variously either as an attribute of an individual or as a structural phenomenon. People with a desire for power not only enjoy being in charge but also accumulate all the symbols and emoluments of power. They prefer to work in a competitive and status oriented situations and tend to be more concerned with gaining influence over others and with their prestige than with effective performance.

Need for Achievement: Need for achievement is a desire to excel and achieve a particular goal. The goal is set in relation to a standard and so the individual who is most motivated in this way will strive to accomplish their goal through entrepreneurship.

Entrepreneurs characteristically like to take personal responsibility for finding solutions to problems, they like repaid feedback and they aim to achieve moderately difficult tasks, that is, tasks which have a challenge but not beyond their capabilities.

Profit: Many entrepreneurs are enticed by the hefty profits of a highly successful business, although the odds in favor of such considerable success are slim. Others are motivated by

making their own money in business. Surprisingly, however, many entrepreneurs do not rate money as a primary motivator for starting their own businesses.

Role Models: perhaps one of the most important factors influencing entrepreneurs in their carrier choices is role models. Role models can be parents, brothers or sisters, other relatives, or successful entrepreneurs in the surrounding community or nationally touted individual entrepreneurs.

Highly visible role models seem to stimulate entrepreneurial activity. Watching others' successes drive individuals to start their own business. Entrepreneurs often describe being inspired to start their entrepreneurial career by another entrepreneur, a parent, a local business person, or a famous entrepreneur.

Push Factors

Push factors on the other hand are those which encourage entrepreneurship by making the conventional option less attractive. Many people are pushed (forced) in to founding a new business by variety of factors. Some of the push factors include:

An Alternative to a Dissatisfying Job: Many entrepreneurs are former executives and employees of larger corporations who were highly dissatisfied with their jobs. Some were bored with their work and frustrated with the corporation's disinterest in their ideas. Others were frustrated by the slow decision making, the bureaucracy, and their limited autonomy as managers in large companies.

An important factor that influences someone to start an entrepreneurial career is dissatisfaction with traditional careers that involve working for someone else, often a large organization. Slow career progress, the inability to effect quick changes within the organization, low wages, and office politics are just some of the reasons cited for this dissatisfaction.

Job Insecurity: Given the substantial risks and uncertainty of entrepreneurship, personal security may seem unlikely motivator. However, in a time of much corporate downsizing and layoffs, some entrepreneurs view running their own business as a more secure alternative, especially those in the middle and latter stages of their corporate careers.

Personal and Professional Growth: The challenges of building a business innately involve individual growth. To be successful, an entrepreneur must be able to cope with risk, uncertainty, and stress, handle many different interpersonal relationships, and manage a business with limited resources. Many individuals become entrepreneurs to experience this growth and the fulfillment gained from building a business in to a purposeful, productive entity.

Unemployment: Some individuals start their own business when they fail to get employment. Self- employment is taken as the best alternative for those who are not employed. When unemployment increases, many people start their own business and become entrepreneurs.

A need for seeking for refugee or to escape from environmental factors: There are a number of environmental factors that "push" people to find new firms. These entrepreneurs are motivated as much or more by entrepreneurial rewards than by an "escapist or refugee" mind set. There are different types of refugees that become reasons for establishing their own business.

- The foreign refugees: These are individuals who escape the political, religious, or economic constraints of their homelands by crossing their national boundaries. These individuals when they first enter into a new country they frequently face a lot of problems and may not get salaried employment. As a result, many of them go into establishing their own business.
- The corporate refugees: These are individuals who flee or leave the bureaucratic environment of organizations by going into their business for themselves.
- The parental (paternal) refugees: are those who leave a family business to show the parent that "I can do it alone."
- The feminist refugees: are those who experiences discrimination and decide (elect) to start a firm in which they can free themselves from household responsibilities.
- The society refugees: are those who sense some alienation from the prevailing culture and express it by indulging or entering in entrepreneurial activity.
- The educational refugees: are those who try an academic program and decide to leave and enter the "real world" by going into a new business.

2.4 SUCCESS FACTORS FOR ENTREPRENEURS

Several success factors are apparent from research on innovation and entrepreneurship. We now have fairly solid evidence of what it takes to succeed in a new venture, and although there will always be exceptions; most new ventures succeed because their founders are capable individuals. The following part tries to give brief account on success factors for entrepreneurs.

- **The Entrepreneurial Team:** At the top of the success factor list is the “entrepreneurial team.” The term “team” is used because, more often than not, entrepreneurs do not start business by themselves; they have teams, partners, close associates, or extensive networks of advisors. An entrepreneurial team is usually headed by an individual who provides the critical profile of success. This focal entrepreneur typically has an above-average education, with about 35 percent of technical entrepreneurs holding graduate degrees. Most entrepreneurs started their business when they were in their 30s, and they had solid job experience. Most technical entrepreneurs tend to start business closely related to what they did in previous career positions. Those in non technical areas often leverage their experience in – marketing, merchandising, or a professional service area such as insurance or finance. We can infer that success is closely tied to solid knowledge base and substantial experience in related field of endeavor. They will also have well-developed social and business relationships, and therefore have a strong foundation for building a team support network.

- **Venture Product or Service:** Nearly all successful ventures start small and grow incrementally, few "gear-up" with substantial organizations for a big-bang start. Incremental expansion of products and services also tend to stay within the bounds of positive cash flow. Products tend to have strong profit potential with high initial margins rather than small margins that requires substantial volume of sale to meet profit objectives. Service businesses retain good margins by effective cost controls, and well-monitored overheads.

  In each instance, products and services tend to display a distinctive competency in their industries. This is important because very few entrepreneurs start business in already competitive situations. Entrepreneurs Corollary to this rule is that successful entrepreneurs should "stick to their knitting" by concentrating initially on one distinct product or service, making it successful before diversifying.

  From an investor's viewpoint, the product or service idea is secondary to the entrepreneur. A popular expression among investors is that they would rather "back a first-rate entrepreneur with a second-rate product than the other way round". This guideline does not mean the business concept can be weak, but it does suggest that investors must have considerable confidence in the entrepreneurial team before buying into the venture.

- **Market and Timing:** Successful entrepreneurs tend to have clear vision of both existing and potential customers. A crucial aspect of planning is to have a well-documented forecast of sales based on sensible projections at each stage of incremental growth. A charismatic entrepreneur loaded with talent and a great idea will not convince investors that a venture is viable without valid market research. There are no short cuts; and as noted early, there are windows of opportunity that can lead to exceptional success.

- **Business Ideology:** from an entrepreneur's perspective, every venture has an ideology, a philosophy, or rationale for existing. Although the ideology may be extremely difficult to quantify, it is nevertheless important. A business ideology is defined as a system of beliefs about how one conducts an enterprise. These beliefs include – a commitment to provide customers with value, the ability to take calculated risks, the determination to grow and to control the fate the business, the propensity to elicit cooperation among team members, and the perspective of creating wealth realistically. A business ideology may not be entirely defined by these notions, but failure is often blamed on one of them. For example, rarely do we hear that a business failed because the product was flawed, but more often because the firm lost track of its commitment to customers.

Chapter Three

Alternative Business Ownership Opportunities

3.1 CREATING AN ENTIRELY NEW BUSINESS

Building businesses from scratch (a start up) is the route most often thought of when discussing new-venture creation. This requires the entrepreneur to identify a genuine business opportunity, secure the necessary financial resource to create the venture, acquire labor, material and capital resources, create an organizational structure by defining the authority and responsibility of each person and position in the enterprise, and launch the business with the intention of creating an enterprise which has its own public image and reputation.

The first impression most people have about this alternative is that it is difficult and involves a whole lot of hard work. But in spite of its difficulty, it is preferable in certain situations:

- When the entrepreneur wants to avoid undesirable precedents, policies, procedures, and legal commitments of existing firms
- When the entrepreneur wants to make the decision concerning the ideal location, equipment, products or services, employees, suppliers, and bankers by him/herself
- When the entrepreneur has developed a new product or service that necessitates new type of business

Advantages of starting a new business from scratch

Whatever the reason for starting an entirely new business might be, it offers the entrepreneur with the following advantages:

- Greater leeway in deciding where his/her products or services will be marketed; where the business will be located; and which individuals will be hired
- No preexisting equipments and inventory; the entrepreneur will choose only the equipments and inventory that are necessary according to the particular needs of the business
- Customer contacts and relationships are new; which permits the entrepreneur to establish his/her own reputation and a unique image
- The entrepreneur can create a business that reflects his personality
- There is no previous ill will to contend with
- It gives the entrepreneur an opportunity to provide a unique product or service to the market
- Credit connections are new; and a relationship with lenders can be developed from the beginning

- Suppliers are not predetermined; which means they can be evaluated and chosen according to the entrepreneur's needs

Disadvantages of starting from scratch

Although this alternative has the above mentioned advantages, it poses the following problems:

- Obtaining credit or getting investors for the business may be more difficult because the business is not yet established
- Starting and organizing a new business will take more time and energy than buying an existing business
- A customer base that has confidence in the company's product or service will have to be established, which might take time
- It is not certain that the business opportunity identified by the entrepreneur will be both operationally and marketwise feasible
- Estimating costs and making other forecasts become very difficult because the enterprise does not have a prior operational history. This in turn makes making important operational decisions very difficult

Process of creating a new business from scratch

Creating an entirely new business is a complex process that involves a number of important and highly interrelated activities and decisions that need to be performed step by step.

- **Identifying a genuine business opportunity-** The first step in the business creation process is to identify a good business opportunity. Entrepreneurs can generate a business idea from various sources that might include: previous work experiences, personal interests/hobbies, education/courses, chance happenings …and so on. Whatever the source of the new idea maybe, it can fall under any of the following three general categories:
  - Type A ideas involve providing customers with a product or service that does not exist in their market but already exists somewhere else
  - Type B ideas involve a technically new process
  - Type C ideas involve concepts for performing old functions in anew and an improved way.

Whatever type of business opportunity is involved, it must be genuine. Meaning, the new business must have some type of advantage that will provide a competitive edge. This special edge is necessary because the market place does not generally welcome a new competitor. The prospective entrepreneur must visualize some new product or service or location or 'angle' that will not only "get the foot in the door" but keep it there.

- **Developing a business plan-** This is an important step in the venture creation process which is usually overlooked by most entrepreneurs. Developing a business plan helps the entrepreneur to critically analyze the proposed venture to determine the genuineness of the opportunity, identify

potential problems and challenges that might be encountered in the process, and develop various strategies that enable the entrepreneur exploit the opportunity and deal with problems.

- **Implementing the business plan-** The third step in the new venture creation process is to implement the plan by acquiring the necessary resources, hiring employees, and creating an organizational structure
- **Managing the enterprise created:** At this stage, most of the decisions to be made by the entrepreneur will become routine. The entrepreneur will be responsible for supervising the day to day operation of the new enterprise. He/she is also expected to deal with issues concerning expansion, merger and acquisitions, legal challenges… and so on.

3.2 BUYING AN EXISTING BUSINESS (ACQUISITION)

Would be entrepreneurs may decide to buy an already existing business as an alternative to starting a new business from scratch. But this decision must be preceded by a thorough analysis of the advantages and disadvantages of this alternative.

Advantages of acquisition

Acquiring an existing business offers the following advantages to the entrepreneur:

- It reduces the time and cost associated with establishing a new business
- It reduces the uncertainty involved in launching an entirely new venture. A successful going concern has demonstrated its ability to attract customers, to control cost, and make a profit
- An existing business may be available at what seems to be a bargain price
- Existing records of the business are on hand and can be used as guides in running the business
- The buyer of an existing business typically acquires its personnel, inventories, physical facilities, established banking connections, and ongoing relations with suppliers
- It provides a chance to eliminate one competitor.

Disadvantages of acquisition

- Ill-will may exist as a result of the way the business was managed
- The employees who are currently working for the business may be incompetent, may not be able to adapt to the new management style employed by the entrepreneur, or may resist change
- The business may be overpriced
- Acquisition of outdated inventory and obsolete equipments
- The business might have undesirable legal commitments with suppliers, trade unions, customers, or employees
- The personality of the business reflects its previous owner, as a result, it may take a long time to change the personality of the business, especially, if it is bad

The acquisition process

Acquiring an existing business involves the following steps:

- **Finding a business to buy-** An entrepreneur can make use of different sources to locate a business that is for sale which might include business brokers and realtors, advertising, local chamber of commerce, trade publications and newspapers, trade suppliers, accountants, attorneys, bankers… and so on.

- **Evaluating the existing business to be bought-** An entrepreneur, before he/she decides to buy a business offered for sale, must carefully evaluate the business to determine whether or not it is worth buying. In doing so, the entrepreneur needs to have certain information:
    - Reason for selling the business
    - The business's past performance and reputation
    - The presence of any unfavorable legal obligations

The owner of the business can be a good source of information; but it is advisable that the entrepreneur uses additional sources like customers, bankers, suppliers, employees, and thoroughly investigating the internal records of the venture. When evaluating the business, it is very important to seek the assistance of external professionals like accountants and lawyers.

As part of the evaluation process, the entrepreneur is expected to estimate the value of the business. To do this the entrepreneur can make use of different techniques which include:

- **Book value method-** This method uses a company's financial statements to establish the net worth of the firm. It is also called the "balance sheet method" and the "net worth approach." Using balance sheet data, liabilities are subtracted from the value of tangible assets to derive the value of the business without considering good will. The book value of a business is not necessarily its market value or a fair value for buying or selling it. All tangible assets must be evaluated in order to correct inaccuracies that result from accelerated depreciation, bad debts, obsolescence, and usefulness. Specifically, accounts receivable will seldom be worth their face value because of overdue payments, uncollectible (i.e., bad debt write-offs), and customer returns. Inventory is valued at full cost only when it is entirely salable; more often, inventory is devalued to account for slow-moving items, potentially obsolete stock, and allowances for breakage, poor quality, and warranty replacements. Book value for equipments and facilities will be adjusted to reflect market or useful value. Using the book valuation method also requires a subjective evaluation of intangible assets

- **Multiple of earnings method-** When the buyer intends to continue an existing business, the multiple of earnings method is used to capitalize net income. A value is established by multiplying net annual income by a factor that accounts for

risk, future income potential, and the buyer's expectations for investment pay back. A risky business, one with low growth potential, may have a multiplier of only 2. Consequently, a business that has generated on average $20,000 net income during the past several years will be valued at $40,000. If the buyer puts forward a $40,000 bid, he or she is saying, in effect, that the business is either too risky or has too little potential, and the buyer wants a "payback" in two years.

- **Discounted future earnings-** This approach is also called the "present value" model because it uses net present value (NPV) technique to derive a value based on future earnings. Specifically, expectations for future net cash receipts are "discounted" to reflect present values. These discounted future net cash receipts are added to a projected future cash value of the enterprise to provide an offering price.

  These NPV techniques are used to estimate "present" value of "future" receipts, and in order to do so, a discount rate must be established. The discount rate is a risk adjusted return expected from a comparable investment. If, for example, a person could earn 7% interest on a risk-free government security, and a relatively low-risk business opportunity seems to justify a small 2% premium, then the discount rate for valuing the business would be 9%. If the business seems to be risky, a large risk premium of 10% could be assigned, resulting in a 17% discounting rate.

There are additional considerations that can raise or lower the purchase price. The present value assumes, for example, a cash equity investment. In many instances, the buyer will have to borrow most of the purchase price, and if the loan interest is substantial, the discount rate will rise, thereby reducing the purchase prices, or, alternatively, interest costs will be deducted from net cash flow. If the buyer will also operate the new business, then allowance must be made for an equitable salary or draw against business profits. This will further reduce net annual cash flow and the purchase price.

On the other hand, the seller may self-finance a significant portion of the purchase price through a note or a profit-sharing contract. Payments to the seller may reduce cash flow, but risk sharing by the seller can also reduce the discount rate. The lower discount rate results in a higher net present value and higher purchase prices, therefore, how the acquisition is structured and financed will influence decisions by both buyers and sellers.
In addition to the price of the business, the entrepreneur must consider other important factors that include: competition, market (size and trends in the market), future community developments (construction of public buildings, municipally operated parking lots, or a public park; change from a two-way traffic flow to one way flow; and discontinuance of bus routes that allow public transportation for customers and employees), legal commitments, union contracts, building (the quality of the building housing the business), future national emergencies (the impact of price and wage controls, energy shortages, and human resource shortages), and product prices.

- ➢ **Negotiating the purchase price and terms-** Once the entrepreneur has some idea about the probable selling price of the business, he/she can safely initiate the

negotiation process-the primary objective, of course, being to secure a low selling price. But focusing on the final selling price of the business should not divert the attention of the entrepreneur from other elements of the sale. These elements include terms of payment, taxes, loan arrangements… etc.

- **Closing the deal-** As in the purchase of real estate, the purchase of a business is closed at a specific time. The closing may be handled by a title company or an attorney. Preferably, the closing should occur under the direction of an independent third party. If the seller's attorney is suggested as the closing agent, the buyer should exercise caution. Regardless of the closing arrangements, the buyer should never go through a closing without extensive consultation with a qualified attorney.

  A number of important documents are completed during the closing. These include a bill of sale and agreements pertaining to future payments and related guarantees to the seller.

3.3 FRANCHISING

It is the third business ownership alternative available for an entrepreneur and can be defined as a business arrangement or opportunity whereby the manufacturer or sole distributor of a trademarked product or service gives exclusive rights of local distribution to independent retailers in return for their payment of royalties and conformance to standardized operating procedures. The party offering the franchise is called the franchisor while the franchisee is the party who purchases the franchise. And the legal arrangement between these two parties is called the franchise.

The United States Department of Commerce provides a broader definition: "Franchising is a method of doing business by which a franchisee is granted the right to engage in offering, selling, or distributing goods or services under a marketing format which is designed by the franchisor. The franchisor permits the franchisee to use the franchisor's trademark, name and advertising."

Franchising can be approached from the perspective of both the franchisor and the franchisee. For a franchisor, franchising allows the expansion of a proven concept and method of operation from a single unit to large operation with multiple locations and multiple product or service offerings. The franchisee has the opportunity to use proven methods of operation, large-scale, high impact advertising, recognized brands or trademarks, and the continuing management and technical assistance. These advantages are not available to the independent entrepreneur who may be selling the same product or service.

A franchisor uses the franchisee's community goodwill, financial equity, business location, and personal drive and motivation to expand the franchised business. The franchisee uses the franchisor's brand or trademark, proven methods of operation, marketing resources, and technical advice to enter, develop, and maintain customer demand, and ultimately to succeed as an entrepreneur within the community. The franchisee is often given an opportunity to be

part of the operation with limited capital and prior experience, while having a very good chance of success.

This business arrangement or franchise opportunity has three major components: (1) a trademark and/ or logo, (2) the use of the product or service following a marketing plan, and (3) a payment of royalty fee. These components constitute the essence of what is generally referred to as a franchise, whether the arrangement happens to be in auto and truck sales, convenience food stores, restaurants, cleaning services, gasoline retailing, or a host of other products and services.

Types of franchising

These are different forms of franchising opportunities. These different forms of franchising opportunities can be grouped into different classes on the basis of different dimensions. Hence, we can classify franchises by using the nature of the franchising agreement or the parties involved in the agreement.

Types of franchise based on franchising arrangements- On the basis of this dimension, there can be at least four types of different franchising arrangements.

- **Product and trade name franchising-** This type exists when a franchisor gives a franchisee the right to use a widely recognized product or trade name. Product and trade-name franchising has evolved from suppliers making sales contacts with dealers to buy or sell certain products or product lines. In this relationship, the dealer acquires the trade name, trademark, and/or product from the supplier. The dealer (franchisee) identifies with the supplier (franchisor) through the product line. Historically, this approach to franchising has consisted of distribution from a single supplier (or manufacturer) to a large number of dealers either directly or through regional supply centers. This franchising approach has been used in the auto and truck, soft drink, tire, and gasoline service industries.
- **Business format franchising-** This arrangement provides the franchisee an entire marketing system and an ongoing process of assistance and guidance. Business format franchising is concerned with the format or operations procedures to be used by a franchisee in providing the franchisor's product or service line to the customer. Fast food outlets and business services are examples of this type of franchising.
- **Piggyback franchising-** This form refers to the operation of a retail franchise within the physical facilities of a host store. Examples would be a cookie franchise doing business in side a fast food outlet or a car phone franchise with in an automobile dealership. This type of franchise benefits both parties. The host store is able to add a new product line, and the franchise is located near to the customer.
- **Master franchising (sub franchising) -** a master franchisor is an individual who has a continuing contractual relationship with a franchisor to sell its franchises.

This independent business person is a type of a sales agent. Master franchisors are responsible for finding new franchisees within a specified territory.

Types of franchise based on the parties involved in the agreement: Depending on the parties involved in a franchising arrangement and the level they occupy in the value chain, there are three different franchising systems:

- **System A franchise-** In this system a producer or creator of a product gives franchising rights to a wholesaler. This system is common in the soft drink industry. Examples include Coca Cola, Pepsi Cola, and Dr Pepper…etc.
- **System B franchise-** In this case, the franchisor is a wholesaler instead of a producer. This system prevails among super markets and general merchandising stores.
- **System C franchise-** This is a widely used system, and the franchisor is a producer/creator while the franchisee is a retailer. Automobile dealerships and gasoline service stations are prototypes of this system.

Advantages and Disadvantages of Franchising

Franchising is an alternative business growth and expansion strategy for the franchisor while it can be an alternative business ownership opportunity for the franchisee. Hence, the advantages and disadvantages of franchising can be discussed from two perspectives- the franchisee and franchisor.

Advantages to the franchisee

The franchisee gains a number of potential advantages from being involved in a franchising relationship. Some of these have been mentioned briefly before. The following paragraphs elaborate on these and others.

- **Product acceptance or established product or service:** The major advantage to the franchisee, as previously discussed, is that the franchisee enters a business that has an established, highly marketed product or service name. Consumers are already aware of the name and reputation of the product or service the franchisee will be offering. This advantage is assured to the franchisee by the fact that every year large franchisors spend millions of advertising dollars to keep the public aware of their products or services. Such franchisors will generally spend a large portion of their advertising budget on campaigns through television commercials and full-page advertisement on popular magazines.

- **Technical and managerial Assistance:** A second advantage to the franchisee is the technical and managerial assistance provided by the franchisor. The franchisee benefits from the accumulated experience and knowledge of the franchising organization. Franchisors provide the instruction necessary to operate a franchise unit, including on-the-job training in a pilot store. Once operating the unit, the franchisee receives assistance in managing day-to-day operations as well as advice for dealing with crisis situations. Therefore, a

person can enter without prior experience in that particular field because the franchisor will supply the pilot training needed to develop experience and will provide follow-up assistance once the franchised unit has begun operations.

Most business consultants would warn a potential entrepreneur not to attempt a business venture in unfamiliar field. Franchising provides the opportunity to do exactly that and be successful. In fact, some franchisors prefer franchisees that have no prior experience in their particular business field. The franchisor can then train the new franchisee in the methods and procedures of the franchising company, and to be unlearned and no bad habits to break. Some franchisors are looking not for people who know the industry but for those who are motivated and willing to follow instructions.

In addition to managerial guidance, the franchisee will receive technical assistance from the franchisor. Technical assistance often includes location and site selection, store layout and design, store remodeling, inventory control and suggested stock purchases, equipment and fixture purchasing, and the grand opening of the store. It should be noted that although many franchisors provide these specific services, some provide only selected types of assistance. The types of technical assistance provided are usually what the franchisor has found to be absolutely essential for helping the franchisee to be successful. A franchise should therefore realize that a full range of technical assistance is not always part of the franchising package.

- **Financial assistance-**Starting a new venture can be costly in terms of both time and money. The franchise offers an opportunity to start a new venture with up-front support that could save the entrepreneur significant time and possibly capital. Some franchisors conduct location analysis and market research of the area that might include an assessment of traffic, demographics, business conditions, and competition. In some cases, the franchisor will also finance the initial investment to start the franchise operation. The initial capital required to purchase a franchise generally reflects a fee for the franchise, construction costs, and the purchase of equipment.

  The layout of the facility, control of stock and inventory, and the potential buying power of the entire franchise operation can save the entrepreneur significant funds. The size of the parent company can be advantageous in the purchase of health care and business insurance, since the entrepreneur would be considered a participant of the entire franchise organization. Savings in start-up are also reflected in the pooling of monies by individual franchisees for advertising and sales promotion.

- **Marketing advantages-** Any established franchise business offers the entrepreneur years of experience in the business and knowledge of the market. This knowledge is usually reflected in a plan offered to the franchisee that details the profile of the target customer and the strategies that should be

implemented once the operation has begun. This is particularly important because of regional and local differences in markets. Competition, media effectiveness, and tastes can vary widely from one market to another. Given their experience, franchisors can provide advice and assistance in accommodating any of these differences. Most franchisors will be constantly evaluating market condition and determining the most effective strategies to be communicated to the franchisees. Newsletters and other publications that reflect new ideas and developments in the overall market are continually sent to the franchisees.

- **Operating and structural controls-** two problems that many entrepreneurs have in starting a new venture are maintaining quality control of products and services and establishing effective managerial controls. The franchisor, particularly in the food business, will identify purveyors and suppliers that meet the quality standards established. In some instances, the suppliers are actually provided by the franchisor. Standardization in the supplies, products, and services provided helps ensure that the entrepreneur will maintain quality standards that are so important. Standardization also supports a consistent image on which the franchise business depends for expansion.

  Administrative controls usually involve financial decisions relating to costs, inventory, and cash flow, and personnel issues such as criteria for hiring/firing, scheduling, and training to ensure consistent service to the customer. These controls will usually be outlined in a manual supplied to the franchisee upon completion of the franchise deal.

- **Quality control Standards:** The quality control standard imposed by the franchisor upon the franchisee is another potential advantage. Properly administered and controlled, such standards help the franchise to achieve constructive, positive results by ensuring product or service uniformity throughout the franchise system. By setting and maintaining high standards, a franchisor does the franchisee genuine service. Often franchisees appreciate having standard methods of operation and product or service delivery. If the reason for quality standards being maintained is clearly understood, the franchisee will learn what operations and performance are necessary to be a success. Further, standards of quality are vital in presenting consistent patronage image, ensuring return business, maintaining employee morale and pride in work, and instilling in employees the value of team work.

  Why would a franchisee want to continually have to meet standards imposed by someone else? As long as the quality standards are assessed and maintained in a good manner, the standards serve both the franchisor and the franchisee. For example, in franchised restaurants, if franchisees courteously and efficiently serve an appealing meal in an attractive and comfortable setting, they have a better chance to attract and maintain a large, loyal clientele, which clearly benefits the franchisor as well.

- **Less Operating Capital:** In many cases an entrepreneur can open a franchised business with less cash than if an independent business were started. Often, a franchisee can start with considerably less operating capital because the business may not require as much inventory as a comparable non-franchised business. The knowledge and experience of the franchisor concerning how much stock is needed and when to reorder can dramatically reduce the potential for aging of stock, waste or spoilage of perishables, unprofitable storage of low-demand items. Also, a new franchisee may be able to receive some financial assistance from the franchisor or from the franchisor's financial sources. Other specifics associated with a new venture, such as having access to existing architectural drawings for the store and knowing how best to use the floor space for the product or service, can save the franchisee countless hours and dollars.

  Other facets of this advantage can be realized once the business is in operation. A franchisee can expect to share in certain collateral benefits, such as a business insurance and health insurance that, because of the group buying power of the parent company, are often less expensive than the same coverage sought independently. A franchisee can also expect to have a higher profit margin than a comparable independent business owner because of group franchising power and other benefits of associating with the franchisor. This, of course, returns cash to the franchisee.

- Opportunities for Growth: The other advantage to the franchise concerns growth opportunities for operating the territorial franchises. The growth opportunities may come either from negotiating a territorial franchise or from the availability of additional single-unit franchises. A territorial franchise guarantees that there will be no competition from the same franchisor within the specified geographic boundaries. A territorial franchisee may sub-franchise or license other persons to operate stores within the allotted area. Even in the case of single-unit franchisee, sometimes called operating franchisees, additional units can often be added either within the local geographical area or in other areas. Existing franchisees decide to retire or more areas and achieve much of their own growth through opening more units.

Accompanying all these advantages is the devise and assistance available from the franchisor that the franchisee could not have gained without years of experience in the field. This opportunity to benefit from another's experience – to learn from someone else's mistakes – is a primarily advantage of entering a franchising relationship. However, these advantages have to be tempered with a disclaimer since they may not accrue to every franchisee. What might be a decided advantage to one could be in consequential to another.

Advantages to the franchisor

Just as there are major advantages for the potential franchisee to enter relationship with a franchisor, there are significant advantages for the franchisor. Even though the franchisor appears to be the major player of the two, the franchisor simply cannot achieve the amount of growth alone that can be gained through the franchise relationship. Thus, it is important to consider the advantages of franchising from the franchisor's viewpoint.

- **Expansion:** Perhaps the single greatest reason for an entrepreneur to create a franchising chain is to allow a business to expand with limited capital, limited risk, and limited equity investment. A franchisor does not have to spend large sum of money or incur major debt to expand the business into new location. Franchisors can authorize and then place franchised operations in selected areas gradually or they can choose to develop business locations throughout a region or country. A franchised company requires few managers and therefore has a lower staff payroll and fewer staff problems. This provides a greater likelihood of effective monitoring and control of company operations. Also, a franchisor may find potential investors willing to buy into a franchised company if the company is seen to promise continuing profitability. Similarly, persons with little or no experience in the franchisor's business field may be willing to buy a franchise as a potentially profitable investment. Thus, franchising can attract capital through direct investment in the parent company or through the sale of franchises to be used for expansion of the franchise system.

  A related advantage is that the franchising approach provides an opportunity for the parent company to expand into geographic areas that otherwise might not be likely locations for expansion. When a franchised company contract with a franchisee within a particular community, that franchisee may be able to acquire a commercial site that the parent company would be unable to acquire. Communities may be more willing to work with local entrepreneurs than with a remote corporation. Therefore, zoning and other local regulations may be more easily obtained by franchisees than by large corporation from another country.

  Expanding through franchising also simplifies the management structure and reporting requirements associated with expansion. Significant growth by a traditional corporation required the formation of a sizable management structure to develop, implement, monitor, and control the enhanced level of operations. The capacity of the firm's management to control the business activity may not be sufficient to keep pace with the growth of the business itself. In contrast, rapid expansion through franchising network enables the franchisor to devote more time to operational planning, market analysis and assessment, quality control, and strategies for improving the franchise system itself.

- **Cost advantages-** The mere size of a franchised company offers may advantages to the franchisor. The franchisor can purchase supplies in large

quantities, thus achieving economies of scale that would not have been possible otherwise. Many franchise businesses produce parts, accessories, packaging, and raw materials in large quantities, then in return sell these to the franchisees. The franchisee is usually required to purchase these items as part of the franchise agreement, and they usually benefit from lower prices.

One of the biggest cost advantages of franchising for a business is the ability to commit larger sums of money to advertising. Each franchisee contributes a percentage of sales (1to 2%) to an advertising pool. This pooling of resources allows the franchisor to conduct advertising in major media across a wide geographic area. If the business had not been franchised, the company would have had to provide funds for the entire advertising budget.
Franchise revenues - In addition to cost advantage, franchising provides the franchisor with a lot of revenue in the form of initial franchise fees, royalties fees, sales of products and supplies, real estate income, fees for services like bookkeeping, purchasing contracts, legal assistance, marketing research…etc, and promotional fees.

- **Motivation:** A major advantage of franchising as opposed to expanding company owned outlets is that franchisees are generally more highly motivated than company-employed managers. When a franchised unit is operated by an owner rather than a company-employed manager, that unit will usually benefit from the owner's motivation, self-direction, and personal interest in the success of that operation. In addition, the franchisee is often a respected and influential member of the local community, which may result in greater community support of the venture.

- **Shared Advertising:** In a typical franchise relationship, the franchisee pays advertising fee of 1 percent or 2 percent of sales to the franchisor in addition to the royalty fee. This is then combined with the franchisor's commitment to advertising in order to provide a greater financial investment in advertising. This combined amount is sufficient in most cases to offer all inclusive advertising. This provides economics of scale since a single ad can typically be run in all market areas. If the expansion were through company-owned units only, the parent company would have to underwrite all the cost of advertising for the entire chain. Since more capital would have been spent in the operation of the units, less would be available for advertising purpose.

Disadvantages to the franchisee
Most franchising agreements work well for both the franchisor and the franchisee. The franchise agreement is meant to develop a strong relationship between these two mutually bound profit seekers. The franchising approach helps both to realize profits and develop healthy and prosperous business life. However, there are some disadvantages to the franchisee that can be associated with the franchising relationship.

- **Cost of franchise-**The franchise cost consists of several components. Only after all of these cost components have been examined can a realistic picture be drawn. The cost of a franchise begins with the franchise fee. Other costs include royalty payments, promotion costs, inventory and supplies cost, and building and equipment costs. When these costs are considered with the franchise fee, the total investment may look surprisingly large. If entrepreneurs could earn the same income independently, they would save the amount of these fees and some of the other costs. However, this is not a valid objection if the franchisor provides the benefits previously described. In that case, franchisees are merely paying for the advantages of their relationship with the franchisor.

- **Restriction on growth-** A basic way to achieve business growth is to expand the existing sales territory. However, many franchise contracts restrict the franchisee to a defined sales territory, thereby eliminating this form of growth. Usually, the franchisor agrees not to grant another franchise to operate within the same territory. The potential franchisee, therefore, should weigh territorial limitation against the advantages cited earlier.

- **Loss of absolute independence-** Frequently, individuals leave salaried employment for entrepreneurship because they dislike working under the direct supervision and control of others. By entering in to a franchise relationship, such individuals may simply find that a different pattern of close control over personal endeavors has taken over. The franchisee does surrender a considerable amount of independence upon signing a franchise agreement.

  Even though the franchisor's regulation of business operations may be helpful in assuring success, it may be unpleasant to an entrepreneur who cherishes independence. In addition, some franchise contracts go to extremes by covering unimportant details or specifying practices that are more helpful to others in the chain than to the local operation. Thus, as an operator of a franchised business, the entrepreneur occupies the position of a semi-independent businessperson.

Disadvantages to the franchisor

Franchising is by no means a miraculous or problem-free solution to a distribution problem. The idea of using money belonging to other individuals to finance the major part of a business expansion is no doubt exciting, but the application of that idea can be fraught with difficulty. The foremost problem or challenge is how to maintain control of the expanding franchise system and oversee the general operations of each business. In addition, a franchisee may in time re-evaluate the franchising relationship and come to the conclusion that the particular business unit would be better off without the franchisor. Major disadvantages of franchising to the franchisor are discussed below.

Within the franchisor-franchisee relationship, there are three categories of potential disadvantages for the franchisor. These are problems of recruitment, communication, and freedom.

- **Recruitment:** The recruitment problem concerns the difficulty of finding promising franchisee. While there are many who seek franchising as a means to enter business, most lack the experience and motivation and many do not have the proper capital backing they will need to become successful franchisee. In addition, prospective franchisees may not fully realize the amount of time, work, and responsibility required to own and operate an ongoing franchised business.

- **Communication:** As in any business relationship, communication problem can arise. The franchise agreement should be well written in clear language in order to minimize difficulties and misunderstandings. This is particularly true in regard to royalty and other fee payment formulas. Most franchisees pay fee to the franchisor on the basis of the franchised unit's gross income. Some franchisee may have a difference of opinion as to what constitutes "gross income," or may be reluctant to disclose gross income figures to the franchisor. For this reason it is important that the formula for determining any fees or royalties be clearly stated in written franchising agreement and understood by both parties. When such understandings exist, the likelihood of resentments based on unclear language or personal intent can be minimized.

- **Loss of Freedom:** The third potential relationship problem concerns the franchisor's loss of freedom as a new franchisee becomes part of the franchise system. Independent businesspersons can easily make decisions and change policies within their organizations. But once a franchise system is developed, the franchisor or patent company must get permission from franchisees to introduce new products, to add or eliminate services, or to change operating policies. Thus, the franchisor stands to lose a substantial amount of control once a franchise system increases in size to any great degree. It can become extremely difficult for the franchisor to modify the product or process in order to meet the ever changing needs of customers, particularly if the franchise system is spread across a large geographic area containing varied consumer markets.

The franchising process

The quality of franchising as an ownership opportunity highly depends on the image, reputation, and historical success of the franchisor; and the kind of rights and privileges granted to the entrepreneur by a franchise contract. Therefore, the entrepreneur, before entering into a franchise arrangement with anyone, must carefully evaluate his/her options and follow certain procedures.

- **Locating a franchise opportunity-** The entrepreneur must first be able to locate a good franchising opportunity. Sources of information in this regard can be

advertisements in news papers and magazines, existing franchise owners, or other publications and personal contacts.

- **Evaluating the franchise offer-** Once a franchise opportunity is found, it must be carefully evaluated. Doing so requires a lot of information which can be obtained from the franchisor himself, existing franchisees, governmental and trade sources, business magazines, and franchise consultants. The entrepreneur, in evaluating franchise offer, should be aware of franchising frauds. There are some unscrupulous fast-buck artists who offer a wide variety of fraudulent schemes to attract the investment of unsuspecting individuals. The franchisor in this case is merely interested in obtaining the capital investment of the franchisee and not in a continuing relationship.

  There are certain areas that the entrepreneur should focus on when evaluating a franchise offer. These include the following:
  - Business experience of the franchisor
  - Business experience of the directors and the chief executives of the franchisor
  - Litigation history of the franchisor
  - Bankruptcy history of the franchisor
  - Initial funds required to be paid by a franchisee
  - Recurring funds required to be paid by a franchisee
  - Financing arrangements
  - Restriction on sales
  - Termination, cancellation, and renewal of the franchise
  - Training programs
  - Financial information concerning the franchisor …etc.

  In most countries, the franchisor is legally obliged to provide the franchisee with a disclosure statement that clarifies the above issues.

- **Initiating the negotiation** Once the entrepreneur has identified and carefully evaluated a franchise opportunity, the next step will be starting talks with the franchisor in order to establish franchising relations. Although disclosure statements provide information necessary to make a sound evaluation of the business opportunity, they are seldom sufficient for actually deciding to contract for a franchise. Disclosure information provides a foundation for negotiations. All the services and types of assistance offered in a franchise contract are subject to negotiations, and experienced entrepreneurs often prefer to handle most of their own activities such as accounting, leasing, purchasing, employee training, and maintenance. Location decisions are usually made jointly by a franchisor site-selection team and the franchisee, but there may be little latitude for decisions about facilities or unique designs. Some obligations are not negotiable (or have a narrow range of options), including franchise fees, royalty schedules, brand management, inventory, use of proprietary patents, copyrights, and trademarks, and legal rights of both parties.

- **Closing the deal** Few franchise contracts are signed by the prospective franchisee without due diligence and legal assistance. Subsequent to initial meetings with the franchisor, prospective franchisees will take the negotiated proposal to a professional accountant or attorney experienced in due-diligence research for thorough review. This is not an act of mistrust by the franchisee, but only sensible behavior, and most reputable franchisors will insist on a legal review of the propos

3.4 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.

Intellectual Property This refers to exclusive right given to the entrepreneur to benefit from his/her innovations and creations; which 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 Ethiopia, an individual must write an application to the Ethiopian Science and Technology Institution. The application should have three parts:

- **Introduction** This should contain the background and advantages of the invention and the nature of problems that it overcomes. It should also 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, and 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 within 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

i. 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. Trademark 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 trademark may permit others to use it by granting them a license in return for a royalty's fee. The owner of the trademark 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 trademark as a brand name and begins to think of it merely as a general category of goods. The trademark owner has a responsibility to make sure that this does not happen. If the trademark owner fails to do so, he/she will lose his/her legal rights to the trademark because the source of the good or service can no longer be identified.

The law forbids the use of someone else's trademark 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 trademark owner.

ii. 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.

iii. 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.

iv. 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 include:

- ✓ **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.

CHAPTER FOUR

SMALL BUSINESSES AS VITAL COMPONENT OF THE ECONOMY

4.1 DEFINITION OF SMALL BUSINESS

Specifically any size 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 a 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 businesses.

Similarly, most would agree that the major automobile manufacturers are big businesses. And firms of in between sizes would be classified as large or small on the basis of individual viewpoints. There are different dimensions or approaches to define small business. All the available dimensions, with this material we use the size criterion to provide a detail account on small businesses.

Definition of Small Business on Size Criterion

Even the criteria used to measure the size of business vary. Some criteria are applicable to all industrial areas, while, others are relevant only to certain types of business. Examples of criteria used to measure size are:

- number of employees
- sales volume
- asset size
- insurance in force
- volume of deposits

Although the first criterion listed above – 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 clear image of a small business discussed in this material, we suggest the following general size criteria for defining a small business:

1. Financing of the business by one individual or a small group. Only in rare cases would the business have more than 15 or 20 0wners.
2. Except for its marketing function, the firm's operations are geographically localized.
3. Compared to the biggest firms in the industry, the business is small.
4. The number of employees in the business is usually fewer than 100.

Obviously, some small firms fail to meet all the above standards. For example, a small executive search firm – a firm that helps corporate clients, recruits, managers from other organizations – may operate in many sections and thereby fail to meet the second criterion. Nevertheless, the discussion of management concepts in this material is aimed primarily at the type of firm that fits the general pattern just described.

4.2 THE CONTRIBUTION OF SMALL BUSINESSES TO THE ECONOMY

As part of business community, small firms unquestionably contribute to the nation's economic welfare. They produce a substantial portion of the total goods and services. Thus, their general economic contribution is similar to that of big businesses. Small firms, however, possess some qualities that make them more than miniature versions of big business corporations. They make exceptional contributions as they provide new jobs, introduce innovations, stimulate competition, aid big business, and produce goods and services efficiently. The following section presents these contributions in some detail.

Provide New Jobs

As the population and the economy grow, small businesses must provide many of the new job opportunities. It seems clear, indeed, that small businesses must produce the "lion's share" of the new job. Data released by the office of Advocacy of the U.S., Small Business Administration, show clearly the special contribution of small firms in expansion of employment. Small firms are the leader in adding jobs. Firms with fewer than 20 employees add more jobs than firms of 500 or more employees. In fact, small and medium-size firms, those with fewer than 500 employees, accounted for almost two-thirds of all jobs added in the economy.

Of course, as newer firms grow in employment size, they become part of the big business sector. We would also note that not all small firms grow at an even rate.

> It is thus incorrect to speak of small enterprises as a uniformity expanding and active group. It is better to think of them as a large collection of seeds, a few of which sprout and become large plants. Their job-creating powers flow from the few, not the many.

New jobs, therefore, come from the birth of new firms and their subsequent expansion. Also, some growth in employment comes from large corporations that expand and create additional jobs.

Introducing Innovation

New products that originate in the research laboratories of big business make a valuable contribution to our standards of living. There is question, however, as to the relative importance

of big business in achieving the truly significant innovations. The record shows that many scientific breakthroughs originated with independent inventors and small organizations. The following is a list of some of the twentieth-century examples of new products created by small firms:

1. Photocopiers
2. Insulin
3. Vacuum tube
4. Penicillin
5. Jet engine
6. Helicopter

It is interesting to note those research departments of big businesses tend to emphasize the improvement of existing products. In fact, it is quite likely that some ideas generated by personnel in big businesses are sidetracked because they are not related to existing products or because of their unusual nature. Unfortunately, preoccupation with an existing product can sometime blind one to the value of new idea. The jet engine, for example, had difficulty winning the attention of those who were accustomed to international combustion engines.
Studies of innovation have shown the greater effectiveness of small firms in research and development, and that small firms are superior innovators in both increasing-employment and decreasing-employment industries. Others believe that small companies are somewhere between 1.8 and 2.8 times as innovative per employee as large companies. Innovation contributes to productivity by providing better products and better methods of production. The millions of small firms that provide the centers of initiative and source of innovation are thus in a position to help improve productivity.

Stimulating Economic Competition

Many economists, beginning with Adam Smith, have expounded the value inherent in economic competition. In a competitive business situation, individuals are driven by self-interest to act in a socially desirable manner. When producers consist of only a few big businesses, however, the customer is at their mercy. They may set high prices, withhold technological developments, exclude new competitors, or otherwise abuse their position of power. If competition is to have a "cutting edge," there is need for small firms.

Even socialist economies such as that of China tolerate and encourage the formation of small businesses as a means of stimulating economic growth. As China's leaders have in recent years introduced elements of capitalism, including privately owned businesses, the country has experienced a dramatic rise in living standards. Not every competitive effort of small firms is successful, but big businesses may be kept on their toes by small businesses. However, there is no guarantee of competition in numbers alone. Many tiny firms may be no match for one large firm or even for several firms that dominate an industry.

Aiding Big Business

The fact that some functions are more expertly performed by small business enables small firms to contribute to the success of large ones. If small businesses were suddenly removed from the contemporary scene, big businesses would find themselves saddled with a myriad of activities that they could perform only inefficiently. Two functions that small businesses can perform more

efficiently than big businesses are the distribution function and the supply function. Few large manufacturers of inexpensive consumer products find it desirable to own wholesale and retail outlets. Small businesses act as suppliers and subcontractors for large firms. In addition to supplying services directly to large corporations, small firms provide services to customers of big businesses.

Producing goods and Services Efficiently

In considering the contribution of small businesses, we are concerned with an underlying question of small-business efficiency. Common sense tells us that the efficient size of a business varies with the industry. We can easily recognize, for example, that a big business is better in manufacturing automobiles but that small business is better in repairing them. The continued existence of a small business in a competitive economic system is itself evidence of efficient small operation. If small firms were hopelessly inefficient and making no useful contribution, they would be forced out quickly by stronger competitors. Although research has identified some cost advantages for small firms over big businesses, the economic evidence related firm size and productivity is limited.

4.3 SMALL BUSINESS FAILURE FACTORS

Every year many small business firms cease operations. The most frequent cause is failure to pay debts, in which case it is common for the owner to declare bankruptcy and to seek to accommodate the creditors, such paying them 25 cents on Birr. In other instances, businesses go out of existence because the owners realize that, although currently they are solvent, if they continue operations they will incur debts they cannot meet. In these instances, business failure can be defined as a halt of operations.

Some Specific Causes of Failure

Year after year, the major reason that businesses fail is incompetence. The owners simply do not know how to run the enterprise. They make major mistakes an experienced and well-trained entrepreneur would see quickly and easily side steps. The second most common reason businesses fail is unbalanced experience. This means owners do not have well-rounded experience in the major activities of the business, such as finance, purchasing, selling, and production. Because the owner lacks experience in one or more of these critical areas, the enterprise gradually fails. A third common cause of business failure is lack of managerial experience. The owners simply know how to manage people. A fourth potential reason is lack of experience in the line; that is, the owner has entered a business field in which he or she has very little knowledge. Other common causes of business failure include:

- **Neglect:** Occurs whenever an owner does not pay sufficient attention to the enterprise. The owner who has someone else manage the business while he or she goes fishing often finds the business failing because of neglect.

- **Fraud:** This 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 with the company's money, the business might find itself bankrupt before too long. Of course the owner can sue the individual for recovery of the merchandize and have him and her sent to jail, but that all may happen after the firm' creditors have demanded payment for their merchandize and the owner has had to close the business.
- **Disaster:** This refers to some unforeseen happening or "act of God". If a hurricane hits the area and destroys material sitting 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.

4.4 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 their companies will pass 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.

4.4.1 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.

4.4.1.1 Advantages of Sole proprietorships

Ease and low cost of formation and dissolution

It is simple to establish because there may not be a need for making it formal. Except in those cases where a license is required such as for establishing a barbershop, restaurants, opening a bar, there are no restrictions on either starting or terminating small business operations.

Direct motivation and personal care
In this form of organization, all the profit of the business belongs to one person who faces every loss and this gives great incentive to the owner to take personal care in the business and manage it most efficiently. As only one man is dealing with the business, the proprietor can come into close contact with the customers, he can, gain good- will by attending the customers' demands promptly and satisfactorily.

Freedom and promptness of action
The sole proprietor can take his own decision and there is none to question his authority. He has full authority to make decisions and ultimately he is responsible for the results of his decisions. This type of freedom of action promotes initiative and self-reliance. As there is no need to consult any other person, the sole proprietor can take prompt decisions especially when an emergency arises.

Business Secrecy
In this type of business, it is easy to maintain the secrecy of business. Since confidential information is a key to success of a competitive business, it is unlikely that the owner will leak the information; thus any changes he wants to make regarding business methods or policies can be done without the knowledge of others.

Social Desirability
From the social point of view, the sole proprietorship is desirable as it ensures that too much wealth does not concentrate in a few hands. It may be one of the ways in which equitable distribution of wealth is ensured. Furthermore the limited liability of the proprietor ensures members of the society involve in these forms business organization for their maximum effort, which indirectly helps the society to grow and prosper.

Single Tax
The proprietorship does not pay tax as a business; the profits from the business are the personal income of the owner and are declared on his individual income tax return.

4.4.1.2 Disadvantages of sole proprietorship

Limited resources and size
In this form of organization, the resources that are the capacity and skill are very limited.
As one person is responsible for the business, the capital is limited to his capacity particularly to operate a large-scale enterprise. Lending institutions may hesitate to lend large sum of money and suppliers may be unwilling to make sales in large quantities of items on credits with such a business because it is neither safe nor dependable which results in making the business to remain limited in size.

Limited managerial skill

While running a business, many complex and difficult problems may arise requiring wide array of knowledge in management. This makes the possibility of solving the problems difficult for one person in such form of business especially where the business organization is very large and complex that demands different expertise or knowledge.
A sole proprietor may not be expected to perform every function like purchasing, selling, accounting, hiring and other necessary functions, and lead the business to suffer from being improperly managed.

Unlimited liability
The sole proprietor will be legally liable for all debts of the business. At time of loss and bankruptcy if the business asset is not sufficient to satisfy the obligation to settle debts of creditors, his personal and real property may be required to pay off. This indicates how the owner is committing his personal assets for the business failure.
This concept of unlimited liability is, on the one hand, a source of courage and real devotion. On the other hand it makes the owner to limit his activities only in specified areas restricting himself to involve on every new opportunities.

Uncertain future/death of the owner terminates the business
This kind of business suffers from uncertain future, which means there is instability or lack of certainty; the business may come to an end if the owner cannot continue to run the business due to death, insanity, imprisonment or bankruptcy. If at all there are successors, they may not possess the same degree of self-reliance, drive and ability and this makes the life of the business to be terminated.

Difficulty in hiring and keeping high achievement employees
A good employee of the business may quit because there is no opportunity to obtain an ownership interest in it.

Few fringe benefits
If you are your own boss, you lose many of the fringe benefits that come from working for others.

4.4.2 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.

4.4.2.1 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.

4.4.2.2 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.

4.4.2.3 Advantages of Partnership

Easy to establish

Like the proprietorship, the partnership is easy and inexpensive to establish. The owner must obtain the necessary business licenses and submit a minimal number of forms. In most cases, partners must file a certificate for conducting business as partners, if the business is run under a trade name.

Complimentary skill

In a sole proprietorship, the owner must wear lots of different hats, and not all of them fit well. In successful partnerships, parties' skills and abilities usually complement one another, strengthening the company's managerial foundations.

Division of profit

There are no restrictions on how partners distribute the company's profit as long as they are consistent with the partnership agreement and do not violate the rights of any partner. The partnership agreement should articulate the nature of each partner's contribution and proportional share of the profit. If the partners fail to create an agreement, they share equally in the partnership's profits, even if their original capital contributions are unequal.

Larger pool of capital

The partnership form of ownership can significantly broaden the pool of capital available to the business. Each partner's asset base improves the business's ability to borrow needed fund; together the partners' personal assets will support a larger borrowing capacity.

Ability to attract limited partners

When partners share in owing, operating, and managing a business, they are general partners. General partners have unlimited liability and usually take an active role in managing the business. Limited partners do not participate in the day-to- day management of a company; they typically are only financial investors in the business. A partnership can have any number of limited partners, but there must be at least one general partner. A limited partnership can attract investors by offering them limited liability and the potential to realize a substantial return on their investment if the business is successful. Many individuals find it very profitable to invest in high-potential small business, but only if the disadvantage of unlimited liability while doing so.

Little governmental regulation

Like the proprietorship, the partnership form of operation is not burdened with red tape.

Flexibility

Although not as flexible as sole ownership, the partnership can generally react quickly to changing market conditions because no giant organization stifles quick and creative responses to new opportunities.

Taxation

The partnership itself is not subject to federal taxation. It serves as a conduit for the profit or losses it earns or incurs; its net income or losses are passed along to the partners as personal income, and the partners pay income tax on their distributive shares. The partnership, like the proprietorship, avoids the double-taxation disadvantage associated with the corporate form of ownership.

4.4.2.3 Disadvantages of Partnership

Unlimited liability of at least One partner

At least one member of every partnership must be a general partner. The general partner has unlimited personal liability, even though he or she is often the partner with the least personal resources.

Capital accumulation

Although the partnership form of ownership is superior to the proprietorship in its ability to attract capital, it is generally not as effective as the corporate form of ownership.

Difficulty in disposing of partnership interest without dissolving the partnership

Most partnership agreements restrict how a partner can dispose of his share of the business. It is common to find that the partner is required to sell his interest to the remaining partners. Even if the original agreement contains such a requirement and clearly delineates how the value of each partner's ownership will be determined, there is no guarantee that the other partner(s) will have the financial resources to buy the seller's interest. When the money is not available to purchase a partner's interest, the other partner(s) may be forced to accept a new partner, or to dissolve the partnership, distribute the remaining assets, and begin again. When a partner withdraws from the partnership, the partnership ceases to exist unless there are specific provisions in the partnership agreement for a smooth transition. When a general partner dies, becomes incompetent, or withdraws from the business, the partnership automatically dissolves, although it may not terminate. Even when there are numerous partners, if one wishes to disassociate his or her name from the business, the remaining partners will probably form a new partnership.

Lack of continuity

If one partner dies, complications arise. Partnership interest is often nontransferable through inheritance because the remaining partner(s) may not want to be in a partnership with the person who inherits the deceased partner's interest. Partners can make provisions in the partnership agreement to avoid dissolution due to death if all parties agree to accept as partners those who inherit the deceased's interest.

Potential for personality and authority conflict

Being in a partnership is much like being in a marriage. Making sure partners' work habits, goals, ethics, and general business philosophy are compatible is an important step in avoiding a nasty business divorce. Still, as in a marriage, friction among partners is inevitable. The key is having a mechanism such as a partnership agreement and open lines of communication for controlling it. The demise of many partnerships can often be traced to interpersonal conflicts and the lack of procedure to resolve those conflicts.

4.4.3 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.

4.4.3.1 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.

4.4.3.2 Advantages of a corporation

Limited liability of stockholders

The corporation allows investors to limit their liability to the total amount of their investment. This legal protection of personal assets beyond the business is of critical concern to many potential investors.

This shield of limited liability may not be impenetrable, however. Because startup companies are so risky, lenders and other creditors require the owners to personally guarantee loans made to the corporation. By making these guarantees, owners are putting their personal assets at risk despite choosing the corporate form of ownership.

Ability to attract capital

Based on the protection of limited liability, corporations have proved to be the most effective form of ownership for accumulating large amount of capital. Limited only by the number of shares authorized in its charter (which can be amended), the corporation can raise money to begin business and expand as opportunity dictates by selling shares of its stock to investors. A corporation can sell its stock to a limited number of private investors (a private placement) or to the public (a public offering).

Ability to continue indefinitely

Unless limited by its charter, the corporation as a separate legal entity theoretically can continue indefinitely. The corporation's existence does not depend on the fate of any single individual. Unlike a proprietorship or partnership in which the death of a founder ends the business, the corporation lives beyond the lives of those who gave it life. This perpetual life gives rise to the next major advantage – transferable ownership.

Transferable ownership

If stockholders in a corporation are displeased with the business's progress, they can sell their shares to someone else. Millions of shares of stock representing ownership in companies are traded daily on the world's stock exchanges. Shareholders can also transfer their stock through inheritance to a new generation of owners. During all of these transfers of ownership, the corporation continues to conduct business as usual.

Unlike that of large corporations whose shares are traded on organized stock exchanges, the stock of many small corporations is held by a small number of people, often company founders, family members, or employees. The small number of people holding the stock means that the resale market for shares is limited, which could make the transfer of ownership more difficult.

4.4.3.3 Disadvantages of a Corporation

Cost and time involved in the incorporation process

Corporations can be costly and time-consuming to establish. The owners are giving birth to an artificial legal entity – and the gestation period can be prolonged for the novice. In some states an attorney must handle incorporation, but in most states entrepreneurs can complete all of the required forms alone. However, an owner must exercise great caution when incorporating without the help of an attorney.

Double taxation

Because a corporation is a separate legal entity, it must pay taxes on its net income at the federal level. Before stockholders receive a penny of its net income as dividends, a corporation must pay these taxes at a corporate tax rate. Then stockholders must pay taxes on the dividends they receive from these same profits at the individual tax rate. Thus, a corporation's profits are taxed twice. Double taxation is a distinct disadvantage of the corporate form of ownership.

Potential for diminished managerial incentives

As corporations grow, they often require additional managerial expertise beyond that which the founder can provide. Because the founder created the company and often has most of his or her personal wealth tied up in it, the entrepreneur has an intense interest in making it a success and is willing to make scarifies for it. Professional managers the entrepreneur brings into help run the business as it grows do not always have the same degree of interest in or loyalty to the company. As a result, the business may suffer without the founder's energy, care, and devotion. One way to minimize this potential problem is to link managers' compensation to the company's financial performance through a profit-sharing or bonus plan. Corporations can also stimulate managers' incentive on the job by creating an employee stock ownership plan in which managers and employees become part or whole owners in the company.

Legal requirements and regulatory red tape

Corporations are subject to more legal and financial requirements than other forms of ownership. Entrepreneurs must resist the temptation to commingle their personal funds with those of the corporation and must meet more stringent requirements for recording and reporting business transactions. They must also hold annual meetings and consult the board of directors about major decisions that are beyond day-to-day operations. Managers may be required to submit some major decisions to the stockholders for approval.

Potential loss of control by the founder(s)

When entrepreneurs sell shares of ownership in their companies, they relinquish some control. Especially when they need large capital infusions for startup or growth, entrepreneurs may have to give up significant amount of control, so much, in fact, that the founder becomes a minority shareholder. Losing majority ownership – and therefore control – in his or her company leaves the founder in a precarious position.

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CHAPTER FIVE
FINANCING THE NEW VENTURE

5.1 THE NEED FOR FINANCE

New and growing ventures require financing for a variety of needs as they develop over time (Table 5.1). 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 5.1 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.

5.2 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. Each of these types of financing will be discussed in depth before considering their appropriateness for specific situations. The following section presents a detailed account on the different sources of finance.

5.2.1 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. We now turn to the various sources of debt capital.

1. **Commercial Banks:**

Commercial banks are by far the most frequently used source of short-term funds by the entrepreneur. Banks tend to be conservative in their lending practices and prefer to make loans to established small businesses rather than to high-risk start-ups. Bankers want to see evidence of a company's successful track record before committing to a loan. They are concerned with a firm's operating past and will scrutinize its records to project its position in the immediate future. They also want proof of the stability of the firm's sales and about the ability of the product or service to generate adequate cash flows to ensure repayment of the loan.

Banks will refuse loan requests when, in their opinion, there is not an excellent chance for repayment of the loan proceeds with interest. Banks view themselves as stewards of the depositors' money and under law have a fiduciary responsibility to depositors. A banker's commodity is money, and once it has left the bank, the banker's control is virtually nonexistent. Banks certainly have methods by which they can legally pursue funds but they are both costly and counterproductive. Therefore, bankers need to feel extremely confident that repayment will occur in a timely manner.

Commercial banks provide ***unsecured*** and ***secured loans***. An unsecured loan is one in which collateral is neither requested nor given, i.e., it is a personal or signature loan. This type of loan is generally short term in nature__ that is, less than one year, and is granted to only the most credit worthy customers. These loans are generally made for a specific purpose such as the purchase of inventory for a specific order. An entrepreneur is granted the loan on the strength of his/her reputation. Unsecured signature loan will have high interest charges.

Secured loans are those with security pledged to the bank as assurance that the loan will be paid. There are many types of security a bank will consider, such as a guarantor another credit worthy person or company that agrees to pay the loan in the event the borrower defaults but most security is in the form of tangible assets pledged as collateral. Hence, if they do make loans to a start up venture, banks like to see sufficient cash flows to repay the loan, ample collateral to secure it. Repayment of the principal is over the term established and comes chiefly from cash.

To secure a bank loan, an entrepreneur typically will have to answer a number of questions. Five of the most common questions, together with descriptive commentaries, follow:

1. What do you plan to do with the money? Do not plan on using funds for a high-risk venture; banks seek the most secure venture possible.
2. How much do you need? Some entrepreneurs go to their bank with no clear idea of how much money they need. All they know is that they want money. The more precisely the entrepreneur can answer this questions the more likely the loan will be granted.

3. When do they need it? Never rush to the bank with immediate requests for money with no plan. Such a strategy shows that the entrepreneur is a poor planner, and most lenders will not want to set involved
4. How long will you need it? The shorter the period of time the entrepreneur needs the money, the more likely he or she is to get the loan. The time at which the loan will be repaid should correspond to some important milestone in the business plan.
5. How will you repay the loan? This is the most important question. What if plans go awry? Can other incomes be diverted to pay off the loan? does collateral exist? Even if a lot of fixed assets exists, the bank may be unimpressed because it knows from experience that assets sold at a liquidation auction bring only a fraction of their value.

Bank Lending Decisions

Due to previous bad loan decisions by banks, banks are far more cautious in lending money since they cannot afford to incur more bad loans. Commercial loan decisions are made only after the loan officer and loan committee do a careful review of the borrower and the financial track record of the business. For this reason the small business owner needs to be aware of the criteria bankers use in evaluating the credit worthiness of loan applicants. Most bankers refer to these criteria as the five Cs of credit: ***Capital, Capacity, Collateral, Character, and conditions.***

1. **CAPITAL:** A small business must have a stable capital base before a bank grants a loan. Otherwise the bank would be making, in effect, a capital investment in the business. Most banks refuse to make loans that are capital investments because the potential for return on the investment is limited strictly to the interest on the loan, and the potential loss would probably exceed the reward. In fact, the most common reasons that banks give for rejecting small business loan applications are under capitalization or too much debt. The bank expects the small business to have an equity base of investment by the owner(s) that will help support the venture during times of financial strain.
2. **CAPACITY**: A synonym for capacity is cash flow. The bank must be convinced of the firm's ability to meet its regular financial obligations and to repay the bank loan, and that takes cash. More small businesses fail from lack of cash than from lack of profit. It is possible for a company to be showing a profit and still has no cash that is, to be technically bankrupt. Bankers expect the small business loan applicant to pass the test of liquidity, especially for short-term loans. The bank studies closely the small company's cash flow position to decide whether or not it meets the capacity required.
3. **COLLATERAL:** Collateral includes any assets the owner pledges to the bank as security for repayment of the loan. If the company defaults on the loan, the bank has the right to sell the collateral and use the proceeds to satisfy the loan. Bankers view the owner's willingness to pledge collateral (personal or business assets) as an indication of dedication to making the venture a success. A sound business plan can improve a banker's attitude toward a venture.
4. **CHARACTER:** Before approving a loan to a small business, the banker must be satisfied with the owner's character. The evaluation of character frequently is based on intangible factors such as honesty, competence, polish, determination, intelligence and ability. Although the qualities judged are abstract, this evaluation plays a critical role in the banker's decision. Loan officers know that most small businesses fail because of incompetent management, and so they try to avoid extending loans to high-risk managers.

The business plan and a polished presentation by the entrepreneur can go far in convincing the banker of the owner's capability.

5. **CONDITIONS:** The conditions surrounding a loan request also affect the owner's chance of receiving funds. Banks consider factors relating to the business operation such as potential growth in the market, competition, location, form of ownership, and loan purpose. Again, the owner should provide this relevant information in an organized format in the business plan. Another important condition influencing the banker's decision is the shape of the overall economy including interest rate levels, inflation rate, and demand for money. Although these factors are beyond an entrepreneur's control, they still are important components in a banker's decision.

The higher a small business scores on these five Cs, the greater its chance will be to receive a loan. The wise entrepreneur keeps this in mind when preparing a business plan and presentation.

2. Non-bank source of debt capital

Banks are not the only source of debt financing. There are some reasons that force entrepreneurs to look beyond the bank:

- To acquire more money
- To overcome banks' conservatism
- To accommodate the diversity of the small business sector
- To nourish success
- To forestall failure
- To reduce dependence on leverage
- To support innovation
- To improve networking and community visibility
- To finance substantive growth.

Let us now turn our attention to non-bank sources of debt financing that entrepreneurs can tap to feed their cash hungry companies.

2.1 Trade credit: It is a credit given by suppliers who sell goods on account. This credit is reflected on the entrepreneur's balance sheet as account payable and in most cases it must be paid in 30 to 90 or more days, interest free. Because of its ready availability, trade credit is an extremely important source of financing to most entrepreneurs. When banks refuse to lend money to a start up business because they see it as a bad credit risk, the owner usually is able to turn to trade credit as a viable source of capital. Getting suppliers to extend credit in the form of delayed payments usually is much easier for a small business than obtaining bank financing.

2.2 Equipment suppliers: Most equipment vendors encourage business owners to purchase their equipment by offering to finance the purchase. This method of financing is similar to trade credit but with slightly different terms. Usually, equipment lenders offer reasonable credit terms with only a modest down payment with the balance financed over the life of the equipment (usually several years). In some cases, the vendors will repurchase equipment for salvage value at the end of its useful life and offer the business owner another credit agreement on new equipment.

2.3 Accounts receivable financing: It is short term financing that involves either the pledge of receivables as collateral for a loan or the sale of receivables (factoring).

Account receivable bank loans are made on a discounted value of the receivables pledged. A bank may make receivable loans on a notification or non-notification plan. Under the notification plan, purchasers of goods are informed that their accounts have been assigned to the bank. They then make payments directly to the bank, which credits them to the borrower's account. Under the non-notification plan, borrowers collect their accounts as usual and then pay off the bank loan.
Factoring is the sale of accounts receivable. Under this arrangement, the receivables are sold, at a discounted value to a factoring company. Some commercial finance companies also do factoring. Under a standard arrangement the factor will buy the client's receivables out right, without recourse, as soon as the client creates them by its shipment of goods to customers. Factoring fits some businesses better than others, and it has become almost traditional in industries such as textiles, furniture manufacturing, clothing manufacturing, toys, shoes, and plastics.

2.4 Credit unions: Credit unions are non-profit financial cooperatives that promote savings and provide credit to their members; they are best known for extending loans. But credit unions do not make loans to just anyone; to qualify for a loan an entrepreneur must be a member. Lending practices at credit unions are very much like those at banks, but they usually are willing to make smaller loans.

2.5 Insurance companies: For many small businesses, life insurance companies can be an important source of business capital. Insurance companies offer two basic types of loans: policy loans and mortgage loans.

Policy loans are extended on the basis of the amount of money paid through premiums into the insurance policy. It usually takes about two years for an insurance policy to accumulate enough cash surrender value to justify a loan against it. Once cash value is accumulated in a policy, an entrepreneur may borrow up to 95 percent of that value for any length of time. Interest is levied annually, but repayment may be deferred indefinitely. However, the amount of insurance coverage is reduced by the amount of the loan. Only insurance policies that build cash value that is, combine a savings plan with insurance coverage, offer the option of borrowing. This includes whole life (permanent insurance), variable life, universal life, and many corporate-owned life insurance policies. Term life insurance, which offers only pure insurance coverage, has no borrowing capacity.

Insurance companies make mortgage loans on a long-term basis on real property. They are based primarily on the value of the real property being purchased. The insurance company will extend a loan of up to 75 to 80 percent of the real estate's value, and will allow a lengthy repayment schedule of over 25 to 30 years so that the payments do not strain the firm's cash flow excessively.

2.6 Bonds (also known as debt securities): A bond is a long-term contract in which the issuer, who is the borrower, agrees to make principal and interest payments on specific dates to the holder of the bond. Bonds have always been a popular source of debt financing for large companies. Few small business owners realize that they can also tap this valuable source of capital. Although, the smallest businesses are not viable candidates for issuing bonds, a growing

number of small companies are finding the funding they need through bonds when banks and other lenders say no.

Although they can help small companies raise much needed capital, bonds have certain disadvantages. The issuing company must follow the same regulations that govern business-selling stock to public investors.

5.2.1.1 Advantages and Disadvantages of Debt Finance

Debt finance is one principal alternative source of finance for a new venture. As the source of finance it has its own strengths and weaknesses.

The main advantages of debt finance

Because the lender does not have a claim to equity in the business, debt does not dilute the owner's ownership interest in the company.

- A lender is entitled only to repayment of the agreed-upon principal of the loan plus interest, and has no direct claim on future profits of the business. If the company is successful, the owners reap a larger portion of the rewards than they would if they had sold stock in the company to investors in order to finance the growth.
- Except in the case of variable rate loans, principal and interest obligations are known amounts which can be forecasted and planned for.
- Interest on the debt can be deducted on the company's tax return, lowering the actual cost of the loan to the company.
- Raising debt capital is less complicated because the company is not required to comply with state and federal securities laws and regulations.
- The company is not required to send periodic mailings to large numbers of investors, hold periodic meetings of shareholders, and seek the vote of shareholders before taking certain actions.

The principal disadvantages of debt finance

- Unlike equity, debt must at some point be repaid.
- Interest is a fixed cost which raises the company's break-even point. High interest costs during difficult financial periods can increase the risk of insolvency. Companies that are too highly leveraged (that have large amounts of debt as compared to equity) often find it difficult to grow because of the high cost of servicing the debt.
- Cash flow is required for both principal and interest payments and must be budgeted for. Most loans are not repayable in varying amounts over time based on the business cycles of the company.

- Debt instruments often contain restrictions on the company's activities, preventing management from pursuing alternative financing options and non-core business opportunities.
- The larger a company's debt-equity ratio, the more risky the company is considered by lenders and investors. Accordingly, a business is limited as to the amount of debt it can carry.
- The company is usually required to pledge assets of the company to the lender as collateral, and owners of the company are in some cases required to personally guarantee repayment of the loan.

5.2.2 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. The following section presents some specific sources of equity financing.

1. Personal Savings

The first place entrepreneurs should take for start up money is in their own pockets. It is the least expensive source of funds available. The sooner you take outside money, the more ownership in your company you will have to surrender; entrepreneurs apparently see the benefits of self-sufficiency; the most common source of equity funds used to start a small business is the entrepreneur's pool of personal savings.

As a general rule, entrepreneurs should expect to provide at least half of the startup funds in the form of equity capital. If the entrepreneur is not willing to risk his own money, potential investors are not likely to risk their money in the business either. Furthermore, if an owner contributes any less than half of the initial capital requirement, he must borrow an excessive amount of capital to fund the business properly, and the high repayment schedule put intense pressure on cash flow. In some cases, however, a creative entrepreneur is able to invest as little as 10 percent of the initial capital requirement. The important point is that an entrepreneur should not surrender all hopes of going into business just because he is unable to provide half of the starting funds.

2. Friends and family

Friends and family are common sources of equity capital for new ventures. Friends and family can be relatively accessible sources of funding for new ventures, and they are sometimes quite willing to invest. This is because they know the entrepreneur. Thus, that portion of the

uncertainty that must be overcome by impersonal investors is eliminated. Furthermore, they may have implicit trust in the entrepreneur and not question the efficacy of the venture concept.

Friends and family typically provide relatively small amounts of equity funding for the ventures. Part of this because many small business ventures need relatively small amount of total funding. There are exceptions to this of course. Obtaining equity funds from friends and family has both advantages and disadvantages. The investment of equity funds means financial ownership. Friends and family who provide equity capital to the venture become part owners with the entrepreneur. The ownership percentage may be small, but it is still part ownership. Thus, the investors may feel that they have a say in the operation of the venture. Sometimes, minor owners suddenly come to the business and demand action from the entrepreneur or attempt to direct employees or redesign facilities. This can be disastrous to the operations of a small or new venture. On the other hand, friends and family are often patient, and do not mind waiting for any return that might be realized from the operation of the firm.

3. Angels

After dipping into their own pockets and convincing friends and relatives to invest in their business ventures, many entrepreneurs still find themselves short of the seed capital they need. Frequently, the next step on the road to business financing is private investors. These private investors (or angles) are wealthy individuals, often entrepreneurs themselves, who invest in business start ups in exchange for equity stakes in the companies.

Angels are a primary source of start-up capital for companies in the embryonic stage through the growth stage and their role in financing small business is significant. Due to the inherent risks in start-up companies, many venture capitalists have shifted their investment portfolios away from start-ups toward more established firms. That is why angel financing is so important. Angles will often finance the deals that no venture capitalists will consider. Most angels have substantial business and financial experience and prefer to invest in companies at the start up or infant growth stage. Angels also look for businesses they know something about and most expect to invest their knowledge, experience and energy as well as their money in a company. Angels tend to invest in clusters as well with the right approach and an entrepreneur can attract an angel who might share the deal with some of his/her close friends or companions.

Angels are an excellent source of "patient money" often willing to wait seven years or longer to cash out their investments. They earn their returns through the increased value of the business, not through dividends and interests. For example, more than 1,000 early investors in Microsoft Inc. (now a giant in computer software industry) are now millionaires. Angles return on investment targets tend to be lower than those of professional venture capitalists. While venture capitalists shoot for 60 percent to 75 percent returns annually, private investors usually settle for 35 percent (depending on the level of risk involved in the venture). Private investors typically take less than 50 percent ownership, leaving the majority ownership to the company founder(s).

4. Partners

An entrepreneur can choose to take on a partner to expand the capital foundation of the proposed business. Before entering into any partnership arrangement, however, the owner must consider

the impact of giving up some personal control over operations and of sharing profits with one or more partners. Whenever an entrepreneur gives up equity in his/her business (through whatever mechanisms), he/she runs the risk of losing control over it. As the founder's ownership in a company becomes increasingly diluted, the probability of losing control of its future direction and the entire decision-making process increases.

5. Venture Capital Companies

Venture capital companies are private, for profit organizations that purchase equity positions in young businesses they believe have high growth and high profit potential. They provide start up (seed-money) capital to new ventures, development funds to businesses in their early growth stage, and expansion funds to rapidly growing ventures that have the potential to "go public" or that need capital for acquisitions.

Small business owners must realize that it is very difficult for any small business, especially fledgling or struggling firms, to pass the intense screening process of a venture capital company and quality for an investment. Two factors make a deal attractive to venture capitalists: ***high returns and a convenient (and profitable) exit strategy.***

Venture capitalists are extremely well informed about the industries in which they invest, and most have experienced market research departments that provide information vital to the enterprise. As stockholders, venture capitalists are anxious to help business succeed, and they provide consultation to assist entrepreneurs in every way possible. Most venture capitalist maintain frequent contact with their entrepreneurs, and through their contacts, they provide access to prospective customers, suppliers, and professional services.

In many instances, they also become "mentors."/advisors. Venture capitalists are involved, but they do not try to take over the business. They are primarily investors and are not interested in managing the business in which they invest. To do so would mean that venture capitalists would have to personally assume management responsibilities for a dozen or more new business every year. Consequently, entrepreneurs are not likely to lose control of their businesses. To the contrary, venture capitalists invest because they are reasonably convinced that entrepreneurs are capable.

6. Public Stock Sale ("going public")

In some cases, entrepreneurs can "go public" by selling shares of stock in their corporation to outside investors. This is an effective method of raising large amounts of capital, but it can be an expensive and time consuming process filled with regulatory nightmares.
Going public is not for every business. In fact, most small companies do not meet the criteria for making a successful public stock offering. It is almost impossible for a start-up company with no track record of success to raise money with a public offering.
Here are some of the advantages to this approach.

- ***Size of capital amount***: Selling securities is one of the fastest ways to raise large sum of capital in a short period of time.
- ***Liquidity-*** The public market provides liquidity for owners since they can readily sell their stock.

- ***Value***: The market place puts a value on the company's stock, which in turn allows value to be placed on the corporation.
- ***Image***: The image of a publicly traded corporation often is stronger in the eyes of suppliers, financers, and customers.

5.2.2.1 Advantages and disadvantages of equity finance

Equity finance can sometimes be more appropriate than other sources of finance, eg bank loans, but it can place different demands on you and your business.

The main advantages of equity finance

The funding is committed to your business and your intended projects. Investors only realize their investment if the business is doing well, eg through stock market flotation or a sale to new investors.

- The right business angels and venture capitalists can bring valuable skills, contacts and experience to your business. They can also assist with strategy and key decision making.
- In common with you, investors have a vested interest in the business' success, ie its growth, profitability and increase in value.
- Investors are often prepared to provide follow-up funding as the business grows.

The principal disadvantages of equity finance

- Raising equity finance is demanding, costly and time consuming. Your business may suffer as you devote time to the deal. Potential investors will seek background information on you and your business - they will closely scrutinize past results and forecasts and will probe the management team. However, many businesses find this discipline useful regardless of whether or not they actually receive any funding.
- Depending on the investor, you will lose a certain amount of your power to make management decisions.
- You will have to invest management time to provide regular information for the investor to monitor.
- At first you will have a smaller share in the business - both as a percentage and in absolute monetary terms. However, your reduced share may become worth a lot more in absolute monetary terms if the investment leads to your business becoming more successful.
- There can be legal and regulatory issues to comply with when raising finance, eg when promoting investments.

5.3 MATCHING FINANCING TO VENTURE DEVELOPMENT

This chapter presented a number of different funding sources for new and existing ventures. However, the capital sources are not all relevant for all ventures in all stages of development. For example, low-growth ventures will never use venture capital because they do not need it and because venture capitalists do not have an interest in intentionally small ventures. Conversely, rapid-growth ventures will not normally use friends and family because they need far more capital than typical friends and family can provide.

The type of funding required is a function of the type or nature of the venture itself, which includes the industry in which it competes and the product or service produced. It is also a function of two major variables: the stage of the venture's development and the amount of growth required.

5.3.1 Stage of Development

The type of financing used is dependent to a large extent on the stage of development of the venture. As discussed earlier, ventures go through at least three stages. The first is the pre-launch stage. In this stage, the entrepreneur or entrepreneurial team plans the venture and determines what the venture concept will be, the level of growth desired, the amount of funding required, and a general idea of the strategies it will use. In some cases, such as a new product development, the team members must do a substantial amount of work to develop and/or test the product and its acceptance before the venture can be begun. Hence, significant funding may be required before the venture can even be lunched. Other ventures, particularly low-growth ventures, do not require significant pre-launch funding.

Start-up funding refers to the capital needed to get the venture into operation. This includes final product development, manufacturing facilities, marketing expenses associated with the launch, setting up distribution networks, and hiring personnel. Although the amount of funding for the launch stage varies greatly with growth orientations and types of ventures, this stage requires a large one-time infusion of capital.

Later stage financing is sometimes considered to be single stage and sometimes considered to be two or more. In either case, this funding is a major infusion of capital to take the venture from initial launch and stabilization along a path toward rapid growth. This will likely require multiple sources of financing and may include venture capital or public stock offering.

5.3.2 Growth Rate

Low-growth ventures and their entrepreneurs are typically restricted to use their own funds in a pre-start-up situation. Their ventures do not have the potential to attract outside funding. If partners are involved, each partner may invest in the concept and family and friends may be enticed to loan limited sums. This capital is quite limited. As the venture is launched, additional funding will be necessary. Again, this usually comes from the entrepreneur's personal fund plus whatever can be raised from family and friends. If the venture concept is sound, bank will usually loan funds. This will depend heavily on whether it is the first venture for the entrepreneur or not, whether the entrepreneur has a track record in a similar business, and whether sufficient

collateral exists. In later stage funding, banks will be more willing to be involved since the entrepreneur will have shown at least some degree of stability and/or growth.

Initial funding for moderate-growth firms will come largely from personal sources and banks. These firms will often be corporation, but the number of stockholders will often be small or the stock will be family held. Banks will typically be willing to lend to these entrepreneurs because they have either an established venture or at least a venture plan that clearly appears to be sound. Depending up on the growth rate desired, personal, bank and internally generated funding may be sufficient. If higher rate of growth are desired than these sources can underwrite, then selling additional stock to acquaintances or to informal investors may be useful.

The high-growth or rapid-growth venture uses different combinations of funding. The entrepreneurial team will often have substantial funds to invest in the venture although their personal funds may still be a small part of the total package. Most entrepreneurs do not have that flexibility, although many rapid-growth entrepreneurs do have substantial personal funds from earlier successful ventures. Large banks, venture capitalists, and informal investors may enter the picture early in the fast growing venture. If the venture goes as planned, however, the need for major infusion of funds will come within few years.

5.4 Developing the Financial Package

In cases where small amount of capital are needed, developing a financial package is relatively simple. It involves putting together a loan request to a bank, asking friends to contribute either debt or equity capital, or perhaps applying for a small business administration loan. The documentation required may be only a brief business plan and whatever papers the lending institution requires. Most of this can be done by the entrepreneur, perhaps an accountant, and the lending institution staff.

CHAPTER SIX
PREPARING A BUSINESS PLAN

6.2 WHY A BUSINESS PLAN?

Although not mandatory, preparing a formal written business plan is very important for a number of reasons:

- The entire business planning process forces the entrepreneur to analyze all aspects of the venture and to prepare an effective strategy to deal with the uncertainties that arise. Thus, a business plan may help an entrepreneur avoid a project doomed to failure.
- The time, effort, and research needed to put together a formal business plan force the entrepreneur to view the venture critically and objectively.
- The competitive, economic, and financial analyses included in the business plan subject the entrepreneur to close scrutiny of his assumptions about the venture's success.
- Since all aspect of the business venture must be addressed in the business plan, the entrepreneur develops and examines operating strategies and expected results for outside evaluators.
- The business plan quantifies objectives, providing measurable benchmarks for comparing forecasts with actual results.
- The completed business plan provides the entrepreneur with a communication tool for outside financial sources as well as an operational tool for guiding the venture towards success.

6.3 WHO SHOULD PREPARE THE BUSINESS PLAN

The business plan should be prepared by the entrepreneur; however, he/she may consult with many other sources in its preparation. Lawyers, accountants, marketing consultants, and engineers are useful in the preparation of the plan. If and when external help is sought in preparing the business plan, the entrepreneur must remain the driving force behind the plan. Seeking the advice and assistance of outside professionals is always wise, but entrepreneurs need to understand every aspect of the business plan, since it is they who come under the scrutiny of financial sources. Thus, the business plan stands as the entrepreneur's description and prediction for his or her venture, and it must be defended by the entrepreneur- simply put, it is the entrepreneur's responsibility.

6.4 WHO READS THE BUSINESS PLAN?

The business plan may be read by employees, bankers, venture capitalists, suppliers, customers, advisors, and consultants. Whoever is expected to read the business plan, can often affect its actual content and focus. Since each of these groups reads the business plan for different purposes, the entrepreneur must be prepared to address all their issues and concerns. However, there are probably three perspectives that should be considered when preparing the plan:

The perspective of the entrepreneur: The entrepreneur understands better than anyone else the creativity and technology involved in the new venture. The entrepreneur must be able to clearly articulate what the venture is all about.

The marketing perspective: Too often the entrepreneur would consider only the product or the technology and not whether or not someone would buy it. But more important than high technology or creative flair is the marketability of a new venture. Referred to as 'market-driven,' this type of enterprise convincingly demonstrates the benefits to users-the particular group of customers it is aiming for- and the existence of a substantial market.

The investor's perspective: This is concentrated with the financial forecast. Sound financial projections are necessary if investors are to evaluate the worth of their investment. This is not to say that the entrepreneur should fill the business plan with spreadsheets of figures. In fact, many venture-capital firms employ a 'projection discount factor,' which merely represents the belief of venture capitalists that successful new ventures usually reach approximately 50% of their projected financial goals. However, a three to five-year financial projection is essential for investors to use in making their judgment of the venture's future success.

6.5 GUIDELINES IN PREPARING A BUSINESS PLAN

Below is a list of recommendations about how to prepare a successful business plan given by experts in venture capital and new venture development. Entrepreneurs need to adhere to these guide lines in order to make the business plan successful in satisfying the needs of various people who read the business plan:

i. **Keep the plan respectably short:** Readers of business plans are important people who refuse to waste their time. Therefore, entrepreneurs must be able to explain the venture not only carefully and clearly but also concisely.

ii. **Organize and package the plan appropriately**: A table of contents, an executive summary, an appendix, exhibits, graphs, proper grammar, a logical arrangement of segments, and overall neatness are critical elements to the effective presentation of the business plan.

iii. **Orient the plan towards the future:** Entrepreneurs should create an air of excitement in the plan by developing trends and forecasts that describe what the venture intends to do and what the opportunities are for the product or service.

iv. **Avoid exaggeration**: Sales potentials, revenue estimates, and the venture's potential growth should not be inflated. Many times, a best-case, worst-case, and probable-case scenario should be developed for the plan. Documentation and research are vital for the credibility of the plan.

v. **Highlight critical risks**: The critical risks segment of the business plan is important in that it demonstrates the entrepreneur's ability to identify potential problems and develop alternative course of action.

vi. **Give an evidence of an effective entrepreneurial team:** The management segment of the business plan should clearly identify the skills of each key person as well as demonstrate how all such persons can effectively work together as a team in managing the venture.

vii. **Do not over diversify:** Focus the attention of the plan on one main opportunity for the venture. A new business should not attempt to create multiple markets nor pursue multiple ventures until it has successfully developed one main strength.

viii. **Identify the target market**: Substantiate the marketability of the venture's product or service by identifying the particular customer niche being sought. This segment of the business plan is pivotal to the success of the other parts. Market research has to be included to demonstrate how this market segment has been identified.

ix. **Keep the plan written in the third person:** Rather than continually stating "I," "we," or "us," the entrepreneur should phrase everything as "he," "they," or "them." In other words, avoid personalizing the plan, and keep the plan objective.

x. **Capture the reader's interest**: Because of the numerous business plan submitted to investors and the small percentage of plans funded, entrepreneurs need to capture the reader's interest right away by starting with the uniqueness of the venture. Use the title page and the executive summary as key tools for capturing the reader's attention and creating a desire to read more.

6.6 CONTENTS AND STRUCTURE OF A BUSINESS PLAN

A detailed business plan usually has ten sections. The ideal length of a plan is 50 pages, although depending on the need for detail, the overall plan can range from 40 to more than 100 pages (including the appendix). Below is the detail discussion of the ten elements of a business plan.

1. **Introductory page:** This is the title or cover page that provides a brief summary of the business plan's contents. The introductory page should contain the following:
    - The name and address of the company
    - The name of the entrepreneur(s), telephone number, fax number, e-mail address and website address if available
    - A paragraph describing the company and the nature of the business
    - The amount of financing needed. The entrepreneur may offer a package, that is, stock, debt, and so on. However, many venture capitalists prefer to structure this package in their own way.
    - A statement of the confidentiality of the report. This is for security purposes and is important for entrepreneur.

2. **Executive summary**: This section of the business plan is prepared after the total plan is written. About 2-3 pages in length, the executive summary should stimulate the interest of the potential investor. This is a very important section of the business plan and should not be taken lightly by the entrepreneur since the investor uses the summary to determine if the entire business plan is worth reading. Thus, it would highlight in a concise and convincing manner the key points in the business plan. Although determining what is important in any executive summary would be difficult since every business plan is different, there are a number of significant issues that should be addressed:

    - The entrepreneur should briefly describe the business concept.
    - Any data that support the opportunity for this venture should be briefly stated.
    - After establishing the reality of the opportunity the executive summary should then state how this opportunity will be pursued.
    - Next the executive summary should highlight some of the key financial results that can be achieved from the implemented marketing strategy.
    - Important experience of entrepreneur(s), any important contracts or other legal documents that are in place, and any other information that is felt can assist in selling the business venture to a potential investor should also be mentioned

3. **Environmental and industry analysis:** It is important to put the new venture in proper context by first conducting environmental analysis to identify trends and changes occurring on a national and international level that may impact the new venture. Examples of these environmental factors include:

    Economy: The entrepreneur should consider trends in the GNP, unemployment, disposable income, and so on.

Culture: An evaluation of cultural changes may consider shifts in the population by demographics, shifts in attitudes, or trends in safety, health, and nutrition as well as concern for the environment.

Technology: Advances in technology are difficult to predict. However, the entrepreneur should consider potential technological developments determined from resources committed by major industries or the government. Being in a market that is rapidly changing due to technological developments will require the entrepreneur to make careful short-term marketing decisions as well as to be prepared contingency plans given any new technologic developments that may affect his/her product or service.

Legal concerns: There are many important legal issues in starting a new business. The entrepreneur must pay attention to any future legislation that might affect the product or service, channel of distribution, price or promotion strategy. The deregulation of prices, restriction on advertising, and safety regulations affecting the product or packaging are examples of legal restriction that can affect any marketing program.

All the above external factors are generally uncontrollable. However, an awareness and assessment of these factors using various sources can provide strong support for the opportunity and can be invaluable in developing the appropriate marketing strategy.

Once environmental scanning has been completed, the entrepreneur should conduct an industry analysis that will focus on specific industry trends. And this includes:

Industry demand: Knowledge of whether the market is growing or declining, the number of new competitors and possible changes in consumer needs are important issues in trying to ascertain the potential business that might be achieved by the new venture.

Competition: The entrepreneur should be aware of who the major competitors are and what their strengths and weaknesses are so that an effective marketing strategy can be implemented.

4. **Description of the venture**: In this section, the entrepreneur must ascertain the size and scope of the business. It should begin with the mission statement. This statement basically describes the nature of the business and what the entrepreneur hopes to accomplish with the business. Other issues that must be discussed in this section include:
    - The product or service
    - The location and size of the business
    - The personnel and office equipment that will be needed
    - The back ground of the entrepreneur(s) and the history of the venture

5. **Marketing Plan:** this section of the business plan describes how the product(s) or service(s) will be distributed, priced, and promoted. Marketing research evidence to support any of the critical marketing decision strategies as well as to forecast sales should be described in this

section. The specific forecasts for product(s) or service(s) are indicated in order to project profitability of the venture.

What is included in the marketing Section?

The executive summary that you have developed briefly describes the products or services that the company will offer. The marketing section of the business plan provides a detailed description of how the company will compete in the market place as it sells those products and services. The marketing section includes:

- A more detailed description of the products and services
- An analysis of the competition
- An examination of the pricing structure
- An explanation of the company's credit policy
- An explanation of the competitive advantage
- A profile of the target market
- A promotional plan

What is Your Product or Service?

A detailed description of the company's products and services is important for two reasons. First, it helps you thoroughly developed the concept, requiring you to move from the idea stage to something more tangible. Second, it helps the reader of your business plan to better understand your business. If you plan to sell a product, the description should include the size weight, shape, packaging, quality and so forth. If you to sell a service describe all of the services you will offer and explain the typical procedures that you will follow.

Who are Your Competitors?

Almost every small business faces competition from both large and small companies. It is important to know the competition thoroughly in order to develop your competitive strategy. An analysis of the competition can be completed by determining their strengths and weaknesses and examining specific aspects of their operation. Do they have large product line? Do they have poor service? Are they strong or weak financially? Do they have a stable workforce or is there a high turnover?

It is important to consider both direct and indirect competition since many entrepreneurs underestimate their competition. For example, if an entrepreneur plans to start a Chinese restaurant, he or she often only considers the number of Chinese restaurant in the area. However, other full-service restaurants are direct competitors, even if they sell Italian food or Ethiopian food. Indirect competitors include any business which sells prepared food including fast food restaurants and grocery stores with take-out menus.

What is Your Pricing Objectives?

It is important to determine what you want to accomplish with your pricing structure. The goals to be achieved with your pricing structure are known as your pricing objectives. Typical pricing objectives may be:

- to achieve a specific dollar amount of profit.
- to achieve a profit level as a percentage of sales.
- to capture a specific share of the market.
- to reach a certain level of sales volume.

Pricing objective should be specific and quantifiable so that at the end of the year, it can be determined if the goals were met.

What are Your Pricing Policies?

Once pricing objectives have been established, you should then determine your pricing policies. Pricing policies are general pricing guidelines that you will follow to achieve your goals. Typical pricing policies might include the following:

- Will you run sales to take advantages of the different seasons or to eliminate seasonal merchandises?
- Will you try to match competitors' prices?
- Will you give employees discounts on merchandise they purchase?
- Will you use coupons to attract customers?

How Will You Determine Your Prices?

Entrepreneurs often use a very simplified approach to pricing without realizing that pricing is a very important part of the marketing strategy. There are many factors that must be considered before prices are established. Some of the considerations are as follows:

- Cost: The pricing structure must cover all costs and provide an acceptable profit margin. If you are selling a product, you must consider your costs to purchase the product from your suppliers. If you provide a service, you must determine the labor costs. The costs to purchase the product and the cost of wages to perform a service are known as direct costs. All other costs incurred in running the business such as rent, utilities, other wages, supplies and so forth must be considered. These are known as your indirect costs. The pricing structure must be designed to cover the direct and indirect costs and provide profit.
- Competitors' Price: The competitors' price cannot be ignored, since customers will consider prices when making their purchase decision. In the previous section of the marketing plan, we provided a method to analyze the competitors. When setting prices, this analysis must be considered. If you competition has poor service, a smaller product selection, and so on, you will be justified in charging a higher price than the competitor. Conversely, If the competition has many advantages compared to your business, you may have to offer a low price in order to compete effectively.
- Effect on Demand: The demand for a product is often affected by the price. If consumers demand less as the price increases and demand more as the price decreases, this is known as an elastic demand. For some products and services, however, the demand does not

change mush if the prices change. This is known as an inelastic demand. So when setting price policies it is a must to consider the price elasticity of demand.

- Image: For many products, a higher price actually results in higher sales, since customers often equate quality and price. If you want customers to perceive your product or service as a high quality item, a higher price is best. One self-employed photographer found that demand for his services increased after he raised his prices. When his prices were too low, consumers assumed that the quality of his work was equally poor.

What Type of Promotion Will You Use?

Promotion may take many forms including the following:

- Direct marketing: Direct marketing includes direct mail, mail-order catalogs, direct selling, telemarketing, direct-response ads through mail, broadcast, and print media.
- Advertising: Advertising consists of non-personal messages directed at a large number of people. Advertising is carried out through media such as radio, television, newspapers, and so forth.
- Sales promotion: sales promotion consists of marketing activities that provide extra value or incentives to the sales force, distributors, or the ultimate consumer. Sales promotions are developed to increase sales.
- Publicity and public relations: Publicity is company information released as news on radio, television, or in newspapers. Publicity is designed to create an awareness of the company and its products. Public relation consists of community activities of a company designed to create a favorable impression with the public.

6. **Production Plan or Operational Plan** If the new venture is a manufacturing operation, a production plan is necessary. This plan should describe the complete manufacturing process. If some or all of the manufacturing process is to be subcontracted, the plan should describe the subcontractor(s), including location, reason for selection, costs, and any contracts that have been completed. If the manufacturing is to be carried out in whole or in part by the entrepreneur, he or she will need to describe the physical plant layout; the machinery and equipment needed to perform the manufacturing operations; raw materials and suppliers' names, addresses, and terms; costs of manufacturing; and any future capital equipment needs. If the venture is not a manufacturing operation but retail store, service, or some other type of non-manufacturing business, this section would be titled operational plan and the entrepreneur would then need to describe the chronological steps in completing a business transaction.

7. **Organizational plan** The organization plan is part of the plan that describes the venture's form of ownership-that is, proprietorship, partnership, or corporation. If the venture is a partnership, the terms of the partnership should be included. If the venture is a corporation, it is important to detail the shares of stock authorized, share options, as well as the names, addresses, and resumes of the directors and officers of the organization. It is also useful to provide an organization chart indicating the line of authority and the responsibilities of the members of the organization.
8. **Assessment of Risk** Every new venture will be faced with some potential hazards, given the particular industry and competitive environment. It is important that the entrepreneur makes an assessment of risk in the following manner:

- ✓ The entrepreneur should indicate the potential risks to the new venture.
- ✓ Then, the entrepreneur should discuss what might happen if these risks become reality- meaning, the impact of each risk on the new venture if it materializes.
- ✓ Finally, the entrepreneur should talk about the strategy that will be employed to prevent, minimize, or respond to the risks should they occur.

Major risks for a new venture could result from a competitor's reaction; weaknesses in the marketing, production, or management team; and new advances in technology that might render the new product obsolete. Even if these factors present no risks to the new venture the entrepreneur should discuss why that is the case.

9. **Financial Plan** The financial plan determines the potential investment commitment needed for the new venture and indicates whether or not the business is financially feasible. Generally, three financial areas are discussed in this section of the plan:
    - ✓ The start-up costs
    - ✓ How the business will be financed
    - ✓ The second major area of information needed is cash flow figures for three years, with the first year's projection provided monthly. Since bills have to be paid at different times of the year, it is important to determine the demand on cash in a monthly basis, especially for the first year. Remember that sales may be irregular; receipts from customers may also be spread out, thus necessitating the borrowing of short-term capital to meet fixed expenses such as salaries and utilities.
    - ✓ The entrepreneur should summarize the forecasted sales and the appropriate expenses at least for the first three years, with the first year's projections provided monthly.
    - ✓ The last financial item needed in this section of the business plan is the projected balance sheet. This shows the financial conditions of the business at a specific time. It summarizes the assets of the business, its liabilities (what is owed), the investment of the entrepreneur and any partners, and retained earnings (or cumulative losses).

Start-up Costs

Start-up costs are costs that are necessary to open the business. Most of these costs will be incurred prior to the time the company opens for business. Start-up costs for business vary by industry, but the following categories are common for most businesses.

- Inventory: Inventory consists of any item you will buy and resell to customers. Estimates of inventory costs can be obtained from companies that will be your suppliers.
- Furniture and Fixtures: Furniture and fixtures include office desks and chairs, shelving, counters, display cases, and so forth. Estimates of costs can be obtained from retailers of these items.
- Machinery and equipment: This category includes computers, cash registers, copiers, fax machines, as well as a special industry items such as manufacturing equipment, construction equipment, and the forth. Entrepreneurs should identify the companies from

which they would purchase the machinery and equipment and obtain the costs for each item.

- Prepaid Expenses: It is often necessary to pay for services before the company is open for business. These prepaid expenses may include legal fees, insurance for the first six months of operation, grand opening advertising and so forth. Determine what expenses must be paid before the company opens and obtain an estimate for each.
- Training costs for employees: When the door opens for business, the employees must know how to perform their jobs efficiently. For this reason, it is usually necessary to hire and train employees before the first day of operation. If they are hired a week or two before opening, they may receive a paycheck before any sale is generated
- Deposits: Many entrepreneurs forget to include deposits in their start-up costs only to find that this amounts thousands of Birr.
- Renovations and/or building purchase: Unless the business operates at home, there will be costs associated with the site. If a location is leased renovations may be required. Renovations to leased property are called leasehold improvements. If the facility is purchased, the sales price is start-up cost and renovation may be added.
- Working Capital: For most businesses, it takes at least several months to develop a good customer base. During this time, the sales volume is not usually sufficient to pay all of the bills. Working capital is a cash reserve to cover monthly expenses until the cash coming into the company every month is equal to or greater than the amount of bills that need to be paid. In general, the working capital amount should cover at least six months' expenses.

How Will The Business Be Financed?

The financing section of the business plan should identify the type of financing that will be used because this may have a financial impact on you and your company. For example, If a large amount of money is borrowed, the company will have substantial loan payments every month which could be burden for a new company. If you use personal assets as collateral for a loan, you could lose them if the business does not succeed. Money that is borrowed, known as debt financing, must be repaid with interest, this is at the same time a burden for a new business. On the other hand, if you plan to obtain private investors, or if friends and relatives will provide funds, you must consider how they will compensate for their investment. Some investors and partners only want financial return, whereas others want to take an active role in making company decisions. So, before you make decisions on how to finance a new venture you need to consider all the alternatives.

The business plan must also state how debt financing will be repaid and what will be given in exchange for equity funds. For loans, the plan should state the number of years over which the loan will be repaid and the interest rate. For equity, the percentage ownership must be stated along with other payments. It is common to reward investors with dividends, which are periodic payments based on the net profit the company. The business plan should therefore state both percentage of ownership for investors and dividends that will be paid.

Projected Financial Statement

The projected financial statements that are included in the business plan are the projected balance sheet statement, the projected income statements, and the projected cash flow statements. The following section discusses these statements.

i. Projected Balance Sheet Statement

The balance sheet compares the possessions of a company and the debts that it owes on a specific day. Therefore, while the income statement records profit or loss over a period of time, the balance sheet only shows the financial situation on a certain day.

Asset: A company's possessions, called asset, may be tangible items such as machinery and equipment, or they may be intangible assets such as patent or goodwill. On the balance sheet, assets are divided into several categories- current, fixed and other.

Current Asset: are those that are easily converted into cash and include the following:

- Cash: All cash on hand in the business and in the business checking and savings accounts is recorded.
- Account Receivable: If a company extends credit and consumers owe for purchases, this is a company asset because it is money that will be received in the future.
- Inventory: All items available for resale are current assets. In a manufacturing firm, the inventory may be separated into two categories- raw materials and finished goods.
- Supplies: All supplies such as shop supplies, office supplies, bags and boxes for customers' packages, and so forth would be included.
- Prepaid expenses: The prepaid expenses listed in start-up costs are considered as a current asset.

Fixed assets are items that are more permanent in nature and are used in business. These include:

- Machinery, equipment, furniture, fixtures: All items listed in your start-up costs in these categories would be fixed assets.
- Land and building: If you purchase land and a building or if you construct a building, this would be shown in the amount of the price paid or the construction costs.
- Renovations: If you spend money for renovations to leased property, this is considered a business asset even though you do not own the property.
- Vehicles: This includes all company cars, trucks, and so on.

A company may have assets that do not fall in the above categories. For example, if you are required to pay deposits for lease or utilities, the money is often held for several years before it is returned. For this reason, it is not considered a current asset and is therefore placed in a category called "other assets." Similarly, a company may have intangible assets such as goodwill or patents; these are included in "other assets."

Liabilities: The liabilities section of the balance sheet includes all debts that the company owes. As with the assets, the liabilities are categorized as current and long term liabilities.

Current liabilities are those liabilities that must be paid within 12 months and include the following:

- Account payable: All bills due for inventory and supplies are included in this category.
- Accrued expenses: Bills due for utilities and other miscellaneous expenses are considered accrued expenses. Also, if employees are paid every two weeks and wages are owed to them when the balance sheet is prepared, these would be included.
- Notes payable: Any short term loans that are due within 12 months from the date of the balance sheet are considered as current liability. Loan payments include both principal (loan repayment) and interest. Only the principal is recorded o the balance sheet.
- Current portion of long-term debt: Even if loan is to be repaid over several years, a portion of the loan is due within the next year. That principal portion due within the next 12 months is considered the current portion of long-term debt. For example, if a loan principal of Birr 10,000 is due over a five year period, and Birr 3,000 of that amount is due within the next year, the Birr 3,000 is considered the current portion of the long-term debt.

Long-term liabilities are those debts or portions of debts that are due more than 12 months from the date of the balance sheet.

Equity: Another category in the balance sheet is called equity, net worth, or capital account. This account represents the difference between the assets and liabilities. Total asset minus total liabilities must equal net worth or equity. The equity includes all the money the entrepreneur has invested from personal funds as well as retained earnings. Retained earnings is an accumulation of all profits and losses of the company from the day it began until the day the balance sheet is prepared. If the company makes profit, retained earnings increases; if the company loses money, retained earning decrease. Although the total equity figure does not necessarily represent the market value of the company, it is an important figure because financial institutions often compare the total liabilities to the total equity if the company applies for loan.

ii. Projected Income statement

The income statement is completed on a periodic basis and records sales, cost of goods sold, expenses and profit or loss.

- Sale: On the income statement, the sales of a company may be listed as “sales,” “income,” or “revenue,” depending on the type of a company. If the statements are completed on an accrual basis, this represents the sales that have been generated, not necessarily those for which payment has been received.
- Cost of Goods Sold: cost of goods sold includes any costs for products, material, or labor that are directly related to sale. In a retail firm, cost of goods sold is the costs paid to suppliers for inventory. In service firms such as housecleaning or maid service businesses, the product cost is very small but labor is the major part of the cost of goods sold.
- Gross Margin: is the difference between sales and costs of goods sold. It shows the markup on the sales or activity of the company.

- Operating Expenses: Include ongoing expenditures that occur in the process of selling and managing the company. As a company grows, the operating expenses may have subcategories such as “selling expenses,” general and administrative expenses,” and so forth.
- Net Profit: Net profit is equal to gross margin minus operating expenses. The full amount is not available to the entrepreneur, however, since income taxes and other cash outlays must deducted from this sum.

iii. Projected Cash Flow Statement

In new – venture creation, the cash flow statement may be the most important document since it sets forth the amount and timing of expected cash inflows and outflows. This section of the business plan should be carefully constructed.

10. **Appendix**: The appendix of the business plan contains any backup material that is not necessary in the text of the document. Reference to any of the documents in the appendix should be made in the plan itself. Information that should be given in the appendix might include:
    - ✓ Letters from customers, distributor, or subcontractors
    - ✓ Any documentation of information- that is, secondary data or primary research data used to support the decisions made in the plan
    - ✓ Leases, contracts or any other types of agreements that have been initiated
    - ✓ Price list from suppliers and competitors … etc.

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