GENERAL BUSINESS EDUCATION

Student Textbook
Grade 11

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FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
MINISTRY OF EDUCATION

AL GHURAIR
PRINTING AND PUBLISHING LLC

Acknowledgements

The redesign, printing and distribution of this student textbook has been funded through the General Education Quality Improvement Project (GEQIP), which aims to improve the quality of education for Grades 1–12 students in government schools throughout Ethiopia.
The Federal Democratic Republic of Ethiopia received funding for GEQIP through credit/financing from the International Development Associations (IDA), the Fast Track Initiative Catalytic Fund (FTI CF) and other development partners – Finland, Italian Development Cooperation, the Netherlands and UK aid from the Department for International Development (DFID).
The Ministry of Education wishes to thank the many individuals, groups and other bodies involved – directly and indirectly – in publishing the textbook and accompanying teacher guide.

Every effort has been made to trace the copyright holders of the images and we apologise in advance for any unintentional omission. We would be pleased to insert the appropriate acknowledgement in any subsequent edition of this publication.

First edition, 2003(E.C.)
ISBN: 978-99944-2-090-2

Developed, printed and distributed for the Federal Democratic Republic of Ethiopia, Ministry of Education by:
Al Ghurair Printing and Publishing House CO. (LLC)
PO Box 5613
Dubai
U.A.E.

In collaboration with
Kuraz International Publisher P.L.C
P.O. Box 100767
Addis Ababa
Ethiopia

Second Edition 2007 (E.C.),
Reprinted in India by Tan Prints India Pvt. Ltd.

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Introduction

Since 1991, Ethiopia has chosen free market economic system as a strategy to social and economic development. Following the adoption of free market oriented economic policy, the new investment policy and economic liberalization measures were enacted to create conducive environment for private investment by local and foreign investors. As a consequence, new private enterprises came into being in various areas with huge amount of capital. New business organizations in the construction, mining, food processing, banking and insurance, floriculture, exporting, etc sectors can be cited as examples for the growth of private investment in the country signifying its contribution towards socio economic development.

Free market economy, nevertheless, presupposes the availability of knowledgeable, skilled and innovative manpower needed by the various economic sectors- agriculture, industry, service and commerce. Skilled labor force plays a critical role in economic and social development. The capacity of producing skilled labor entails putting in place a good training program that enables the people especially the youth to acquire the skill required by the labor market.

To that effect, general business education is included in general education program to be offered at grade eleven and twelve level in preparatory schools. General business education not only serves the purpose of fostering understanding of how business operates in a particular economic system but also contributes towards making the youth be active members of the society.

General business education, as the title suggests, is general and basic. It is a course with an educational intent of providing basic business knowledge that fosters understanding and ability needed to get along well in business. It is to this purpose that this course material is prepared.

The textbook is organized in four chapters in a manner to maintain the logical vertical relationship of the topics. In the first unit, the general nature of business will be presented followed by forms of business enterprises in unit two. In unit three, the way business enterprises are financed and the various sources of finance are discussed. Unit four presents production and production related concepts.

An introduction to each topic is provided at the beginning of each unit followed by specific objectives to be attained after completing each unit. In the content of each unit, activities to be done by you are included so that you can integrate what you have read with what is real in the world of work. Do not hesitate to do them. At the end of each unit, self-assessment questions are provided to assist you and check your progress in understanding the topics. Try to answer them by your own and refer to the content to check for your answer later.

Objectives

Upon the completion of this course, you will be able to:

- acquire knowledge that enables students to make better use of the goods and services of businesses;
- analyze business as a major economic segment in the society;
- acquire prerequisite knowledge and skills as a foundation for further studies in colleges and universities;
- distinguish between the various business environments thereby rendering them intelligent services that are available in the country;

Unit 1

THE NATURE OF BUSINESS

Unit Outcomes:

After studying this unit, you will be able to:

- define business and business enterprises.
- distinguish between human needs and wants.
- state the importance of business enterprises.
- list the different types of business enterprises.
- state the impacts of business environments on business enterprises.
- relate business activities to real life situation.

Introduction

Business enterprises are among the major establishments in any country that influence social and individual life. Business enterprises satisfy our needs and wants by combining resources-(material, finance, human, talent etc) and/or distributing products. Besides, business as a socio-economic activity provides an opportunity to live better by earning income by which individuals fulfill their requirements. Societies and individuals highly depend on business enterprises for their survival and hence business influences individual as well as social life.

People, wherever they live, have always need food to eat, clothes to wear and shelter to live in because these are basic things that are needed for survival. In addition to these basic needs, there are many things that people want to make their lives more comfortable or satisfying. All the enterprises that you encounter on a daily basis to obtain what you need or want are business enterprises. Retail shops which are located in many places around your localities, potter, wood works, metal works, repair shops, barber shops (where you get your haircut) and hotels are some of the few examples of business enterprises. Large enterprises like banks, insurance companies, private colleges and manufacturers of automobiles are also examples of business enterprises. Business enterprises are the engine of growth and productivity. They are key forces in the growth of a million.

Business enterprises are major institutions in every society that greatly influence the way we live. We give value and importance to a truck driver who moves goods quickly from places where they are produced to where they are needed. Small shops make a variety of goods available at a price the buyer is willing to pay. These are only a few examples of the contributions of business enterprises for our daily life. Business enterprises are also social institutions, as they are comprised of human groups working towards goals that agree with the overall goals of a society. In large business enterprises like banks, a number of employees work together. The employees in banks are part of the society with different backgrounds. The existence of such institutions like banks brought employees together to work for one common goal.

Knowledge of business as a socio-economic activity and how it operates to fulfill needs and wants, what activities business performs is essential to productively engage in it. The purpose of this unit is to provide basic knowledge to understand business, the basic values of business enterprises and the various functions performed by them.

Contents of the Unit

In order to achieve the above objectives, you will learn the following topics:

- Definition of business.
- Importance of business enterprises.
- Kinds of businesses.
- The business environment and how it influences business.

? What do you understand by the term business? Compare your answer with the definition of business stated below.

1.1 What is Business?

Business can be defined as *a socio-economic activity that satisfies human needs and wants by providing goods and services for profit to maintain and improve quality of life.* The basic concepts indicated in this definition are briefly discussed here under.

1.1.1. Business is a Socio-Economic Activity

Business is a social activity where large number of people participate in it, individually and/or in-group. It is a group effort to create value that satisfies human requirements. Some people engage in creating goods and services (producers); others make the created goods and services available for timely consumption (distributors); others inform the public about the availability of the goods and services, where they can be obtained and how they are to be used (advertisers). It is the totality of these efforts of different groups conducted in a coordinated manner that brings fulfillment of human requirements. As such, business is social in nature. Business is also an economic activity as it involves the use of economic resources which are scarce in nature. Because such resources are rare, they have to be used as efficiently as possible so that the maximum possible benefit can be obtained.

1.1.2 Business Satisfies Needs and Wants

Business is our principal means of satisfying human needs and wants. Suppose, one afternoon on your way to school, you felt hungry. If you have enough money, you head for the nearest tearoom and buy tea and bread. You begin enjoying tea and bread to satisfy hunger because the tearoom a business enterprise-sold bread and tea for you. Hence, business made it possible for you with what you need and want. But what are needs and wants?

1.1.2.1 Needs

Needs are basic forces that move a person to do something. Some needs involve a person's effort to exist as a physical being. Others involve efforts to build or show ones self-esteem and relationships with others. Those needs that the individuals are forced to fulfill to survive are called **basic needs**. The need for food, clothing and shelter are examples of basic needs. They are basic because one cannot live without satisfying such needs.

Figure. 1.1 Individuals need food for survival

Describe basic needs with examples and state how people in your locality strive to fulfill them.

A human being has also social needs and individual needs. **Social needs** are needs of affection and belonging to the group. At school you need friends to share ideas with. At home you need your family because they will support you. You probably think to marry. The activities that you make to form relationships with others are all examples of social needs.

Figure. 1.2 Individuals need group and affection

Individual needs are needs for self-growth and self-expression. Probably as a student of the college preparatory class, you are aspiring to join colleges and universities. After completing your studies, you may think of working in large organizations. After achieving a certain state of your needs you still desire to improve yourself. The efforts that individuals make to develop themselves with the intention of improving their life styles are examples of individual needs.

Figure. 1.3 Individuals need to grow

1.1.2.2 Wants

Wants are preferences for something that are learned during a person's life. For example, everyone requires drinking something when being thirsty. But some people have learned to take soft drinks to satisfy their needs of thirst instead of water; some prefer beer to soft drinks. Hence wants are preferences to certain things to satisfy needs. Human wants also take many forms as they are shaped by culture and individual personality. For example, many of us in Ethiopia may want *'injera'* to satisfy the need of eating. However, a hungry person in Kenya may want maize porridge to satisfy the need of eating. Both persons in Kenya and Ethiopia have one common thing: they need to eat. But they differ on how they satisfy their needs. Eating *'injera' or* eating porridge was learned from the practices/experiences of their specific society they belong to. Wants are described in terms of objects that will satisfy needs. Needs are more basic than wants.

? Differentiate needs and wants by taking examples from your locality.

As society develops and people are exposed to more objects, their wants not only expands but also shifts. This suggests that human needs and wants shift with the advance of civilization. Yesterday's demand for horses in large cities is replaced by an even greater demand for automobiles and motorcycles. Following these changes, businesses also shift towards satisfying the newly emerging needs and wants by new goods or services. Hence there will always be a wide range of human needs and wants that encourage business to operate in whatever circumstances.

People have unlimited wants but resources are limited. Each nation's or individual resources can be counted. There is no nation in the world, which possess endless resources. Countries could differ in the degree of resources they possess. Some countries could be rich in resources. But what they do posses are counted. In contrast to limited resources, human wants are unlimited. No sooner are some wants satisfied than new once take their place. Human wants are without limit because they multiply as the population grows.

1.1.3 Business Provides Goods and Services

? Can you explain the difference between goods and services supporting with examples. Then read the next section.

In meeting human needs and wants, business provides goods and services to individuals, groups and organizations. Goods and services are means by which people satisfy there needs and wants. A business must provide its customers, whether they are individuals or organizations, with something that they need or want. Otherwise, the business will have no sales, no income and no profit and will be forced to close its doors. Hence the provision of goods and services that satisfy some kind of needs and wants of consumers is the basis for the survival of a business enterprise. But what are goods and services?

1.1.3.1 Goods

Goods are material objects with a typical physical form (shape) such as tables, books, the furniture that you find at your home and other items like television, radios, calculators, automobiles, etc. Goods are objects that you can feel, taste and see. Goods are classified as (I) Consumer goods and (II) Producer goods.

Before discussing consumer goods, let us briefly review what consumers are.

Consumers are people or individuals *who* buy products for their personal or family use. Consumers are made up of individuals and families. Everyone is a consumer. Each of us at least needs to buy goods for our basic necessities of life. Individual consumers are generally those persons that buy goods not for the purpose of making other goods, selling the goods or for using in an organizational setting but for individual consumption.

I. *Consumer goods* are those goods that are purchased by individuals for their personal or family use. Consumer goods usually are characterized by the level/extent of *effort the individual consumer engages to* obtain the goods. Based on the level of effort made, consumer goods are classified into three categories: *convenience goods, shopping goods and specialty goods.*

a) Convenience goods are goods that are bought by the consumer after little buying *effort, purchased* frequently, bought by habit and available in numerous shops, in most cases near to the residence of the consumer. Some of the examples of convenience goods are candies, bars of soaps, sugar and salt. Their price is comparatively low. In the process of buying these goods, the buyer will not, for example, require gathering special information as to how to use them and to buy or not to buy, go far from his/her home, etc. They are habitually known and readily available near to ones home. Further more, if one type of soap, for example, is not available, the consumer will buy another type without much thinking as one can substitute the other.

Figure.1.4 Convenience goods shown above are widely available

b) ***Shopping goods*** are consumer goods that are bought after comparing several features of the product. Their price is relatively higher than that of convenience goods. This feature requires the buyer to collect additional information to explore from the market before deciding to buy. Shopping goods are purchased infrequently and are not readily available in nearby shops as they are sold in a limited number of selected shops. Examples of shopping goods are men's suits, trousers, sweaters, furnitures, shoes, and televisions. Usually shopping goods have a higher unit price than convenience goods.

Figure.1.5. Examples of shopping goods

c) Specialty goods are goods bought by the consumer after a *special buying effort*; purchased very infrequently and are sold in a few exclusive shops. No substitute will be considered for specialty goods. The consumer is looking for goods that he/she will be interested. Price is not a major consideration for specialty goods. Examples of specialty goods are fine jewelry, diamonds, prestige automobiles and expensive perfumes.

Figure. 1.6. Specialty goods are rarely bought by consumers and are found in limited Places

? Differentiate between convenience goods, shopping goods and specialty goods.

Producers are those people and organizations that convert inputs to a more useful product for users. These groups include individuals and organizations, which use hand tools or sophisticated machinery to produce goods for consumers. Producers are also those investors and organizations who supply money to initiate and sustain a business. Producers taken as a whole supply the products and services that are demanded by consumers. Examples of producers are potter, wood worker, metal worker, farmers and those enterprises that produce higher level goods like cars using sophisticated machinery.

Figure. 1.7 An example of a producer

II. ***Producer goods*** are those goods that are bought by individuals and organizations for further processing, or for use in operations, not for personal consumption. Notice that the distinction between a consumer good and a producer good is based on *the purpose for which goods are purchased*. For example, if you buy milk for your personal consumption, then the milk would be classified as a consumer good. However, if the producer of butter bought milk as a raw material, changed to butter, then the milk would be classified as a producer good. Thus producer goods are used to produce other goods or are consumed in the operations of a business or other organizations.

Producer goods can be classified according to how they enter the production process and according to what they cost. There are five groups:

a) Raw materials
b) Component materials
c) Component parts
d) Capital items
e) Supplies

a) ***Raw Materials*** are producer goods, which are bought without being processed. Raw materials enter the production process directly. Raw materials include farm products (wheat, cotton, livestock, fruits, vegetables etc) and natural products (crude oil, timber, iron ore and etc) *that are converted into a useful product or service.* The outputs of the raw materials usually have different shapes and sizes from the input. For example, cotton when processed would be changed to cloth. The raw sheep leather when processed would be changed to shoes or leather coats. In these instances, a cloth or a shoe has different shape and size from the cotton or leather.

b) ***Component materials*** are manufactured materials, which require further processing to fit into the final product. Such materials are usually referred to as semi-finished products that are already manufactured but not consumed as finished products. For example, pig iron is further processed into steel. Fiber is further processed to make clothes.

c) ***Component parts*** usually are not processed by the manufacturer or the manufacturer does not change the form of the component parts. Component parts enter the finished products with no further processing as when tires are fitted to automobiles. Small motors, which activate the machinery, usually are assembled without any processing or changing the form of the motors.

d) ***Capital items*** are producer goods, which require large investments and last for longer period of time. The machinery and buildings that producers use for manufacturing purpose are examples of capital items. Capital items are purchased after longer purchasing decisions and are used for a number of years. Capital items include two groups: Installations and accessory equipment. Installations consist of buildings, machinery, and fixed equipment like generators and large computers. Accessory equipment includes portable factory equipment and tools, which do not become part of finished goods. The price of accessory equipment is much lower than installations. Examples of accessory equipment are hand tools like hammer, office desks and fax machines. Accessory equipment has a shorter life than installations and simple aid in the production process.

e) ***Supplies*** are producer goods, which are consumed in the operation of manufacturing processes. Supplies include such items like lubricants, pencils, nails, brooms and etc, which will be consumed in the operation of the business process.

Activity: 1

Do the following

- **Identify a manufacturing enterprise in your locality and report on the producer goods it uses and the final products it produces.**

? What are services? Can you give example of services that you may need?

1.1.3.2 Services:

Are any activity or benefit that one party can offer to another that is essentially intangible and which does not result in the ownership of anything. Services are activities that help people or organization without directly creating a physical product. Activities such as depositing money in a bank, getting a haircut, medical treatment, watching cinema, using hotels for drinks, having clothes cleaned at a dry cleaner, getting advice from a lawyer are examples of services.

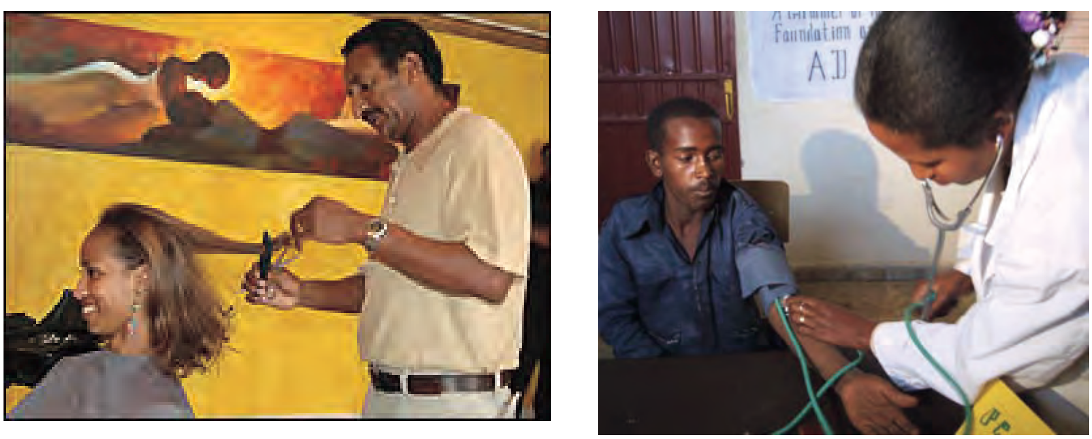

Figure 1.8 Examples of services

? List the factors that distinguish service firms from manufacturing firms. Support your discussion with examples drawn from business experiences in your vicinity.

Services have four characteristics. These are:

a) Intangibility
b) Inseparability
c) Variability
d) Perishability

a) Service intangibility means that service cannot be seen, tasted, felt, heard or smelled before it is bought or consumed. For example, you cannot describe the actors in a movie before watching the cinema. Primarily you must get into the hall or watch movies to describe the characteristics of the actors. This may require buying a ticket in order to get into the hall. If you are sick, you may go to nearby hospitals or health centers. In this situation, the medical personnel must first examine you to be cured from the disease. Such activity primarily requires the service of the medical person. People undergoing surgery cannot see the result before the surgery. Passengers have nothing but a ticket and the promise of safe arrival to their destinations.

Because of intangibility of services, buyers usually look for tangible aspects used for the service provision to judge the quality of the service to be bought. They draw conclusions about service quality from the place, people, equipment, communication material and price that can be charged. As a student when your parents buy for you a school uniform they may choose tailors. The choice of tailors may depend on the price that can be charged, the experience of the tailor or the uniforms/suits that were made by the tailor in the past.

? **What is service intangibility? Provide examples for your answer based on your personal observations.**

b) ***Service Inseparability*** means that services cannot be separated from their providers whether the providers are people or machines. If a person provides a service, then the person is part of the service. For example, when you are going to a barbershop to get your haircut, the barber is part of the activity. Though, the barber is receiving money for his/her service, he/she also is providing service of hair cutting for you. It means that the service cannot be separated from the producer since services are produced and consumed at the same time. In other word, the quality of the service is highly dependent on the service provider and the facilities the service provider uses. Taking the same example of barber, while cutting your hair, he/she is producing the service. Actually when the barber is cutting your hair you are consuming his/her service. Hence the production (hair cutting by the barber) and consumption (service given to you i.e. getting hair cut) are simultaneously done and, at the same time, the quality of the haircut depends on the experience, motivation and skill of the barber.

c) ***Service variability*** means that the quality of service depends on who provides them as well as when, where and how they are provided. For example, some hotels have good names for providing better services than others. The reputations might arise from the way the workers treat the customers or the locations of the hotel. In material production, adding more or improved machines can increase productivity. In the service activity, improved productivity will depend on the workers. For example, in hospitals tools might be important. But above all the quality and the knowledge of the medical persons are more important than the tools. The tools and machines existing in the hospital can never be a substitute for the medical persons such as doctors and nurses.

d) ***Service perishability*** means that service cannot be stored for later sale or use. Producers of goods usually store goods for later sale. However, in services such storage would not exist. For example, in hospitals service-value exists only when the patient is there and disappeared when the patient did not show up. Physical goods are produced then stored, later sold and still later consumed. In contrast services will only exist when consumers exist and after the services are rendered.

1.1.4 Business Intends to Make Private Profit

The primary goal of any business is to make profit. The hope of making private profit and of creating wealth is the main reason why businesses are started and continue to operate. Without private profit, a businessperson would not be encouraged to use his/her skill and creativity to meet consumer demands. Without private profit, investors would not take the risk of providing the capital needed for the business. Profit is the businessperson's payoff for satisfying human needs and wants. In simplest terms, profit is the amount of money left from income made by selling goods and services after all costs of producing, marketing and distributing the goods and services have been paid.

Sometimes, there is no money left over, or costs might turn out to be higher than income. When the costs are greater than the income, the business incurs a loss. The intention of a business, however, is to operate in such a way that profits will be as high as possible, consistent with social responsibility. The incentive to make money is called the profit motive. The profit motive is that which most clearly distinguishes business from other kinds of enterprises. See how profit is computed bellow.

Table 1.1

Profit or Loss?

Company 'A' generated revenue from sales ---	**Birr 100,000**
It deducts the costs for materials, labor, rent-	**90,000**
What is left is its profit	**10,000**
Company 'B' generated revenue from sales ---	**Birr 100,000**
It deducts the costs for materials, labor, rent	**-110,000**
Company 'B' incurred a loss of	**– 10,000**

In the case of company 'A', the revenue is exceeding the cost. As a result, the company gains profit; however, in the case of company 'B', the costs are exceeding the revenue. Hence company 'B' incurs a loss.

Apart from business enterprises, there are also non-profit enterprises. Enterprises, which do not seek profit, are called nonprofit enterprises. The primary aim of such organizations is to satisfy the needs and wants of certain groups or the society at large but primarily not for making a profit. Some of the examples for non- profit organizations are hospitals, museums, and charitable organizations commonly known as NGO's, schools and colleges. The principal difference between business enterprises and non-profit enterprises is the profit motive. i.e. business enterprises have profit motives whereas non-profit organizations do not have.

Activity: 2

1. **Define business enterprises.**
2. **Distinguish between goods and services.**
3. **Name five profit making enterprises in your locality.**
4. **Describe services with their special features. State what makes services different from goods with examples.**

1.2 Importance of Business Enterprises

? Can you identify some of the importance of business enterprises?

Apart from providing profit and other benefits to owners, as discussed in the preceding paragraphs, businesses serve important social functions. Business enterprises serve as:

1. Agents of exchange.
2. Source of income.

3. Agents of socio-cultural interaction.
4. Agent of technological advancement.
5. Source of employment.

1.2.1 Business Serves as an Agent of Exchange

When you buy your books from a bookshop in cash, you are exchanging money for books. This is made possible for you because there is an enterprise that sales book. The fact that certain people and group have goods that others needed and did not have or could not produce for themselves created the need for exchange. Even in early cultures, certain groups of individuals were specialized in producing tools and weapons, while groups of individuals specialized in producing household implements. Certain groups may still specialize in the production of agricultural products. In such instances, the producers of tools and weapons want to consume agricultural products. Simultaneously, the producer of agricultural products will need tools to produce agricultural products. Hence they may exchange tools for agricultural products.

With the development of society in size and complexity, groups who bring various products at a certain place to make it available for all range of people with different needs emerged. This is how trade started. We commonly refer this gradual development as an instance where merchants appeared between the producers and consumers. In today's complex society, we are surrounded by a number of merchants or businesspersons that assemble goods for convenient consumption. Because of the existence of business enterprises, we can easily exchange products. For example, the producer of shoes can easily convert the shoe to cash through selling. With the cash available, the producer can easily buy what is needed for life. This is made possible through the exchange process.

Exchange is the core concept in business. For an exchange to take place, several conditions must be satisfied. First of all, at least two parties, the buyer and seller, must participate, where each party has something of value to exchange with the other. The money that is in the pocket of the buyer is a valuable thing that the seller needs, and the product that the seller offers for sale is also a valuable thing that the buyer wants. Secondly, each party must also want to deal with the other and each must be free to accept or reject the other's offer. Finally, each party must be able to communicate and deliver the items exchanged. The buyer must exchange the money for the goods offered by the seller. These conditions simply make exchange possible.

? Describe exchange as a basis for business with the conditions necessary for exchange.

When an exchange of one value for another value occurred, we say a transaction has taken place.

A transaction is a unit of measurement in exchange.

In transaction products are measured in terms of their equivalence. For example, you pay birr 10 and get a book in return. In this case the value of the book is equivalent to birr 10. When products are exchanged for money, it is a monetary transaction. Specific kinds of goods and services can also be exchanged for other goods and services. In this situation money as a medium of exchange is not involved. Trading goods for goods is bartering. In a barter transaction an axe might be exchanged for sucks of grain. A barter transaction can also involve in services. For example a lawyer may write a will for a doctor in return for a medical examination.

In ancient times when people had no money, they simply traded goods for other goods. A person who had more grain than needed exchange the surplus for fish or something the person lacked. Barter is still practiced to some extent today. For example, trading in an old car as partial payment for a new one is a common practice. Or trading sheep with goats or other livestock are some of the common practices.

Barter, however, has certain drawbacks that can be overcome by the use of money. The drawbacks of the barter system are:

a) Absence of double coincidence of wants
b) Absence of subdivision
c) Difficulty of storage

a) ***Absence of double coincidence of wants:*** Barter requires a double coincidence of wants. For example if a farmer wants a cow and had 4 quintals of grain, he must find someone with a cow that in return need 4 quintals of grain. Such situation would not occur easily because someone that had a cow might need to exchange the cow with a horse. Money, however, overcomes these difficulties. With money, someone can buy whatever he/she wants.

b) ***Absence of subdivision:*** Sometimes it will be difficult to split up commodities into parts. They will lose their value if they are subdivided. For example, if somebody wants to sell an axe and wants to buy some grain and some cloth, it is impossible to divide the axe and give it for all the products that are needed.

c) ***Difficulty of storage***: Money serves as store of value. In the absence of money a person has to sore his/her wealth in the form of commodities and they may not be stored for a long period of time. This so because some commodities are perishable and some will lose their *value.*

? Differentiate between monetary transactions and barter; state the problems associated with the barter transaction.

1.2.2 Business is the Source of Income

Business is the source of income for the owners and for the employees. When the business generates profit, the profit is an income for the owners. When the employees receive their salaries and wages it is an income for employees. By the income generated, owners and employees would sustain their lives. Not only business is as source of income for employees and owners, it also allows the accumulation of wealth. Wealth embraces everything that money can buy not limited to the possession of abundance of money. More specifically, wealth includes material goods, services and leisure all of which have been made available by businesses.

Business enterprises are also sources of income for governments. Business enterprises must pay tax on their profits. The taxes that will be collected from the business enterprises are the major source of income for governments. Taxes are amounts that will be collected from individuals and businesses by governments. You may think why governments would collect taxes. Governments require money to provide public services and for promoting the general well being of the society. For example, the police forces that you are encountering daily maintain peace and safety of the public. In return to the services the policemen rendered to the society, they will be paid salaries. This is one of the examples of expenses that will be incurred by governments. The governments pay such expenses by collecting taxes from individuals and organizations including business enterprises.

Governments obtain income to support their operations from variety of taxes. The most important source of revenue for the government is an income tax. An income tax is a regular payment made to a government by individuals and organizations from their income, which vary by income level. There are two types of income taxes:

Personal and business income tax. Personal income tax is paid based on how much money individuals earn from employment and/or investments. The rate of personal income taxes increases as the individual earns more money. Businesses income taxes are taxes paid by the business enterprises based on profits remaining after all costs of operating business have been deducted.

Activity: 3

1. **List the importance of business enterprises.**
2. **Discuss the shortcomings of barter transactions.**
3. **Identify a kind of barter transaction that may take place in your surroundings.**

Types of Taxes

? Why is it important to pay taxes?

In most countries, individuals pay income taxes when they earn money, consumption taxes when they spend it, property taxes when they own a home or land, and in some case estate taxes when they die.

Taxes on people's incomes play critical roles in the revenue systems of all countries. Personal income taxation is the single largest source of revenue for governments. Payroll taxes, which are used to finance social insurance programs such as social security and medicare, account for almost a large part of federal revenues. States also taxes the incomes of corporations.

State regional governments depend on sales taxes and property taxes as their main sources of funding. Regional states also tax incomes of individuals and corporations, although less heavily than the federal government.

A. An Individual Income Tax, also called a Personal Income Tax

It is a tax on a person's income. Income includes wages, salaries, and other earnings from one's occupation interest earned by savings accounts and certain type of bonds; rents (earnings from rented properties); royalties earned on sales of patented or copyrighted items, such as inventions and books; and dividends from stock. Income also includes capital gains, which are profits from the sale of stock, real estate, or investments whose value has increased over time.

Income taxation enjoys widespread support because income is considered a good indicator of an individual's ability to pay. However, income taxes are hard to administer because measuring income is often difficult. For example, some people receive part of their income "in-kind"—in the form of goods and services rather than in cash. Farmers provide field hands with food, and corporation may give employees access to company cars and free parking space. If governments tax cash income but not in-kind compensation, then people can avoid taxation by taking a higher proportion of their income as in-kind compensation.

As to the Ethiopian Negarit Gazetha of proclamation No. 286/1994/20 [286/2002 G.C] Income tax proclamation defines the applicable tax rate for monthly employment earning. The first 150 birr from employment shall be exempt from payment of income tax in all cases. Tax on income from employment over 150 birr shall be charged and collected monthly according to the following table. The percentage charge for personal income tax of Ethiopia at present is shown in table 1.2.

Table 1.2. Percentage charge of personal income tax based on the income level In Ethiopia as an Example

No	Monthly Income Birr	Percentage of Income Tax
1	1-150	No charge
2	151-650	10%
3	651-1400	15%
4	1401-2350	20%
5	2351-3550	25%
6	3551-5000	30%
7	5000+	35%

The computation of the income tax for the individuals is shown as follows:

Ato Biruk Worku monthly salary 2500 birr

Computation of income tax

Method 1

Earning per tax range × tax rate =	**Salary income tax**
The first 150 × 0	= 0
The next 500 i.e. (650-150) × 10%	= 50
The next 750 i.e. (1400-650) × 15%	= 112.50
The next 950 i.e. (2350 - 1400) × 20%	= 190
The next 150 i.e. (2500-2350) × 25%	= 37.50
Total 2500 Total salary tax	390.00

Income after income tax = 2500- 390 = 2110 birr

Method 2

By using the formula table (Note that x represents Monthly Income Range)

No	Monthly Income Range	Formula
1	1 – 150	No charge
2	151 – 650	0.10 x – 15.00
3	651 – 1400	0.15 x – 47.50
4	1401 – 2350	0.20 x – 117.50
5	2351 – 3550	0.25 x – 235.00
6	3551 – 5000	0.30 x – 412.50
7	5000 +	0.35 x – 662.50

The income tax of Ato Biruk Worku would be computed as follows based on the formula table.

Ato Biruk Worku monthly salary = birr 2500

Taxable income is 2500

Income tax = (2500 × 25%) = 625

625 - 235 = 390

Income after income tax= 2500 - 390 = birr 2110

As shown in table 1.2 above, the percentage of the personal income tax increases as one earns more. For an individual who earns 1-150 birr he/she is not required to pay an income tax. For a person who earns 151-650 he/she is required to pay 10% of income tax as shown in the table. The percentage charge of income tax is shown opposite to the income levels indicated in the table 1.2. The computation of an income tax is illustrated as follows:

Suppose W/o Shashe earns a monthly salary of 700 birr. The amount that she will pay for the income would be computed as follows. Since all individuals are exempted from the first 150birr, this amount would be deducted from the gross amount to determine the taxable amount. Accordingly, 700 – 150 = 550. Since, W/o Shashe's taxable income falls within the range of 151- 650 birr; the tax rate applied is 10% as shown in table 1.2. Thus the amount she would be charged for income tax would be 500×10% = birr 50 and the remaining birr 50 should be taxed as 50 × 15% = 7.5. Now, W/o Shashe is required to pay birr 57.50 for personal income tax out of her gross monthly income of birr 700.00. The computation is summarized as:

700 -150 = 550 (Taxable income)

500 × 10% = birr 50 (Income tax)

50 × 15% = birr 7.5 (Income tax)

700 – 57.5 = birr 642.5 (Income after income tax). It is also known as disposable income or take home money.

Activity: 4

1. **Ask employees that you may know in your vicinity their salary and compute the income tax and the income after the income tax and show for correction for your instructor.**
2. **By taking a particular business enterprise around your locality report the types of taxes the organization pays to local authorities and the rates applied for different taxes.**

B. Corporate Income Tax

The corporate income tax is one of the most controversial types of taxes. Although the law treats corporations as if they have an independent ability to pay a tax, many economists note that only real people-such as the shareholder who own corporations-can bear a tax burden. In addition, the corporate income tax lead to double taxation of corporate income. Income is taxed once when it is earned by the corporation, and a second time when it is paid out to shareholders in the form of dividends. Thus, corporate income faces a higher tax burden than income earned by individuals or by other types of businesses.

C. Payroll Tax

Whereas an income tax is levied on all source of income, a payroll tax applies only to wages and salaries. Employers automatically withhold payroll taxes from employees' wages and forward them to the government. Payroll taxes are the main sources of funding for various social insurance programs, such as those that provide benefits to the poor, elderly, unemployed, and disabled.

D. Consumption Tax

A consumption tax is a tax levied on sales of goods or services. The most important kinds of consumption taxes are general sales taxes, excise taxes, value-added taxes, and tariffs.

i. General Sales Taxes

A general sale tax impose the same tax rate on a wide variety of goods and, in some cases, services. Although sellers are legally responsible for paying sales taxes, and sellers collect sales taxes from consumers, the burden of any given sale tax is often divided between sellers and consumers. Most state exempt certain necessities from sales tax, such as basic groceries and prescription drugs. Both individuals and businesses pay sales tax.

ii. Excise Taxes

Federal, state, and local governments levy excise taxes, which are sale taxes on specific goods or services. Excise taxes are also called elective sales taxes. Goods subject to excise taxes include tobacco products, alcoholic beverages, gasoline, and some luxury items. Excise taxes are applied either on a per unit basis, such as per package of cigarettes or per liter or gallon of gasoline, or as a fixed percentage of the sales price.

Governments sometimes levy excise taxes to pay for specific projects. For example, voters in a city might approve a tax in hotel rooms to help pay for a new convention center. Some national governments impose an excise tax on airline tickets to help pay for airport improvements. Revenues from gasoline taxes typically pay for highway construction and improvements. Excise taxes designed to limit consumption of a commodity, such as taxes on cigarettes and alcoholic beverages, are commonly known as “sin taxes.”

Another type of excise tax is the license tax. Most states require people to buy licenses to engage in certain activities, such as hunting and fishing, operating a motor vehicle, owning a business, and selling alcoholic beverages.

iii. Value-Added Tax /VAT/

The favored form of consumption taxation is a value-added tax (VAT). In this system, the seller pays the government a percentage of the value added to goods or services at each stage of production. The value added at each stage of production is the difference between the seller’s costs for materials and the selling price. In essence, a VAT is just a general sales tax that is collected at multiple stages.

In the production of bread, for example, the farmer grows wheat and sells them to a baker, who turns them into a bread. The baker sells the bread to a restaurant owner, who sells it to a consumer. At each stage, the producer adds value to the commodity by processing it with capital (machines) and labor. The farmer, the baker, and the restaurant owner each charges their customer a VAT. However, they can each claim a credit to recover the tax they paid on purchases related to their commercial activities.

Computations of VAT

The following examples illustrate how VAT is charged as goods move from one vendor to the next in the manufacturing, wholesale and retail chain, until they reach the final consumer.

1. Manufacturer sells to wholesales

at VAT @ 15%		10,000
VAT		1,500
	Total	11,500

2. Whole sales sells to Retailer at

VAT @ 15%		12,000
VAT		1,800
	Total	13,800

{Output Tax--input Tax}
Birr {1,800--1,500}

3. Retailer sells to consumer at

VAT @ 15%		14,400
Final Price including VAT		2,160
		16,560
{Output Tax--input Tax}		
Birr {2,160-1800}		360
	Total Tax	2,160

iv. Tariffs

Tariffs also called duties or customs duties are taxes levied on imported or exported goods. Import duties are considered consumption taxes because they are levied on goods to be consumed. Import duties also protect domestic industries from foreign competition by making imported goods more expensive than their domestic counter parts.

E. Property Taxes

In principle, a property tax is a tax on an individual's wealth--the value of all of the person's assets, both financial (such as stocks and bonds) and real (such as houses, cars, and artwork). In practice, property taxes are usually more limited. The property tax is often unpopular with homeowners. One reason is that, because homes are not sold very often, governments must levy the tax on the estimated value of the dwelling.

F. Estate, Inheritance, and Gift Taxes

When a person dies, the property that he or she leaves for others may be subject to tax. An estate tax is a tax on the deceased person's estate, which includes everything the person owned at the time of death-money, real estate, stock, bonds, proceeds from insurance policies, and material possessions. Most governments levy estate taxes before the deceased person's property passes to heirs, although many governments do not impose an estate tax on property inherited by a spouse. An inheritance tax also taxes passes to heirs. The inheritors pay the tax. Estate and inheritance taxes are sometimes collectively called death taxes. A gift tax is a tax on the transfer of property between living people.

Estate and gift taxes are controversial. Proponents argue that they are useful tools for distributing wealth more equally in society and preventing the rise of powerful oligarchies. Opponents view on the other hand argue that it is a person's right to pass on property to his or her heirs, and the government has no right to interfere. If an individual has paid tax on his or her income while in the process of accumulating wealth, critics ask, why should it be taxed again when the wealth is transferred? Others argue that estate and gift taxes discourage individuals from working and saving to accumulate wealth to leave to their children. On the other hand, the presence of an estate tax might encourage people to accumulate greater wealth in order to reach a given after-tax goal.

G. Other Taxes

A poll tax, also called a lump-sum tax or head tax, collects the same amount of money from each individual regardless of income or circumstances. Poll taxes are not widely used because their burden falls hardest on the poor.

A pollution tax is a tax levied on a company that produces air, water, or soil pollution over a certain level established by the government. The tax provides an incentive for companies to pollute less and thus reduce damage to the environment.

Note the following points:

Direct Taxes are:

- ***Personal income Tax***
- ***Rental tax***
- ***Business Profit Tax***
- ***Withholding Tax***

Indirect taxes are:

- ***VAT***
- ***Excise Tax***
- ***Turnover Tax***

Business Income Tax in Ethiopia is currently calculated as follows: According Proclamation 286/2002 a tax is imposed on commercial, professional or vocational activity or any other activity recognized as trade by the commercial code of Ethiopia and carried on by any person for profit.

- Taxable business income of bodies is taxable at the rate 30%.
- Taxable business income of other taxpayers is tax in accordance with Table 1.3; is given below.

Table 1.3

№		Taxable Business income /per year/	% of the tax	Deduction
01	0	1.800	Exempt Threshold	Free
02	1.801	7800	10	180.00
03	7801	16,800	15	570,00
04	16,801	28,200	20	1410,00
05	28,201	42,600	25	2520,00
06	42,601	60,000	30	4950,00
07	Over 60,000		35	7950,00

Example 1: Computation of business profit tax

- Business Net profit per year/taxable Income = Birr 70500,00
- Business profit Tax =/70,500,00×35%/-7,950.00

=24,675-7,950

= Birr 16,725.00

For deductible expenses of Table 1.3 see proclamation 286/02 and regulation 78/02 Article 8 C_l-8.

A Tax that is imposed on the income from rental of buildings, and if the rent of building with enclosure of house and furniture the income shall be include and taxed.

The tax payable on rented houses shall be charged, levied and collected at following rate.

1. On income bodies thirty percent/30%/ of taxable income;
2. On income of persons according to the Table 1.4

Table 1.4

№	Taxable income For Rental		Deduction	
01	0	1800	Exempt threshold	
02	1801	7,801	10	180.00
03	7801	16,800	15	570.00
04	16,801	28,200	20	1410.00
05	28,201	42,600	25	2520.00
06	42,601	60,000	30	4950.00
07	over 60,000		35	7950.00

Example 2: Computation of Rental income Tax

Net profit per-year/Taxable income = Birr 38,000.00

Rental Income Tax = /3,8000 × 25% - 2,520.00

= 9,500-2520

= Birr 6,980.00

1.2.3 Business Serves as an Agent of Technological Advancement

Technology is the collection of methods a society uses to provide itself with material needs and wants. It embraces all the specific ways of obtaining food, clothing, shelter, security, transportation and the other things they desire. Because of the existence of many business enterprises in any country, there will always be a technological advancement. In a primitive society, technology may mean a body of knowledge about hunting, gathering roots or knowledge of making simple tools. In today's society, technology includes a number of methods. It includes methods of discovering new things or it includes methods of converting resources into more useful form and distributing products to end-users. In these instances, the existence of millions of business enterprises tends to stimulate technological advancement by providing many centers of initiatives and source of innovation.

1.2.4 Business serves as a Source of Employment

One of the greatest social contributions of businesses is to provide employment. You may be surprised to know that one factory will employ many people. The establishment of Sheraton Addis created employment opportunities for many individuals. Even in very small shops, you will find that the owners are employing themselves. In today's society, jobs and careers can be among the most important paths to personal satisfaction. Useful, productive, and rewarding employment can give meaning to people's lives by providing them with a sense of purpose, a feeling of accomplishment and, outlet for creativity. In most countries unemployment is a major problem. This is also true in Ethiopian condition. This problem would be solved if a number of business enterprises exist. One way of creating employment opportunity is to be engaged in business activities through one's own self-initiative depending on one's capacity. When there are many business enterprises there will be an opportunity for many unemployed people to be employed.

1.2.5 Business Serves as an Agent of Socio-Cultural Interaction

Business enterprises are the major agents for the interaction of different societies. When you are buying something you may face a seller who has a different culture than you. Culture is usually defined as the total collection of beliefs and ways of living that develop within a given society.

People grow up in a particular society that shapes their beliefs and values. They absorb a worldview that defines their relationships between themselves and others. Business enterprises play a key role for the interaction of the society. For example, in 'large business enterprises, thousands of workers will be employed. Obviously, the workers will come from different societies. That means they differ in cultures. While their common goal is profit, they will share and interact with different cultures. Such activities allow people to interact with each other. This is made possible by the existence of business enterprises.

? Explain the contribution of business to society apart from producing profit to the owners with examples from your locality?

1.3. Kinds of Business

The many functions of business and the endless possibilities for carrying out the process have resulted in remarkable diversity of business enterprises. Businesses can be classified by type: Production, distribution and service. The classification of business enterprises is elaborated as follows.

1.3.1 Production Enterprises

Production is the process of converting resources into a useful form suitable for consumption/usage. Enterprises that manufacture materials or goods are called **production enterprises**. The production may be on a primary (basic) level, such as mining, farming, or forestry or it may use already manufactured materials to produce higher-level goods. The term "production" is commonly used only for processes where the physical form of materials is changed. Thus manufacturing processes are production processes. Production enterprises are distinguished from other enterprises in that such enterprises are engaged in changing the physical form of materials. They add value to starting materials by reshaping, combining or transforming them.

The different production processes may be described as:

a) extractive
b) analytical
c) fabrication
d) synthesis
e) assembly

a) Extractive Processes take physical resources from the earth, sea or air for use in further manufacturing or directly for consumers. For example, pumping crude oil from the ground, digging out gold ore, growing and harvesting maize and teff, fishing, and chopping trees are all types of extraction activities. While extraction usually provides raw materials for further manufacturing processes, some extracted products such as maize, teff, fish can be sold directly to consumers.

b) Analytical processes break materials down into new and more useful forms. An analytical process separates iron from iron ore. Gold is mined from gold mines. Crude oil is separated into useful components such as gasoline, heating oil and etc.

C) Fabrication Processes change the size or shape of materials and join them together in various ways to create new products. Fabricating may involve cutting parts from sheet metal and forging them into shape, cutting fabric and making it into clothes, cutting and shaping wood into pieces and gluing them together to make furniture. The construction industry fabricates when putting up bridges and buildings. **Fabrication** is the process of making available finished products for sale to final buyers, or it may be the process of creating component parts to be used in further manufacturing.

d) Synthetic Processes create new materials by chemically or physically combining and changing materials. The original materials are no longer distinguishable from the product. Plastics, for example, are synthetics made from binders such as cellulose or synthetic resin and other materials. Many fibers for clothes are made in a similar way while steel is created from iron and other substances.

e) Assembly Processes create products by joining together component parts without changing their shape or composition. Screwing and bolting together the proper component parts like, hubs, spokes, brake parts and so forth can make a bicycle. A new product has been created; but all of the component parts have retained their original physical forms. They have merely been attached to one another. The final manufacturing process for many goods, like automobiles assembly. Previous manufacturing processes from extraction through sub assembly have produced the component parts.

? Describe the different types of production processes with examples.

All processes described above may be continuous or intermittent. **Continuous processes** run for long periods of time with few pauses or changes. For instance, Muger cement factory, St. George Brewery, and auto assembly lines usually operate continuously for months with no essential changes in their production activities.

Intermittent processes are suited to custom products. A custom product is made according to the customer's specifications and design. The specific product is sold only to one customer. The manufacturers of these items are called custom manufactures. Custom goods are not made until an order is placed. The customer usually has sole freedom in determining the specifications of the product. Custom made clothing, for instance, will be cut according to the buyer's measurements and are made of materials that the buyer selects.

Intermittent processes operate for shorter periods, in batches and often only for hours, and are easier to change. Commercial printers, for instance, often use a different set-up for every job. Continuous processes produce standard products. It refers to the idea that a great quantity of the output is produced by the same specifications. Standard products are usually made in advance of sale to unknown customers. Soft drinks, for example, are-made in huge quantities without the producer knowing specifically who will buy them or when the products are going to be sold.

Production processes also differ in the amounts of labor and capital they require. ***Capital-intensive*** processes use expensive equipment, machines and machineries extensively and are less dependent on the activities of workers. For example, electrical power generation is capital-intensive processes. It uses expensive plants and relatively few workers, compared with quantity and value of output. On the other hand in ***labor-intensive processes***, more labor is used than equipments. Workers make a significant contribution to the value of output. The production of hand-carved furniture is an example. The relatively inexpensive starting materials are converted into high-priced products through the application of skill of workers. Many repair services, like automobile repair, or plumbing are labor intensive.

? Distinguish between continuous and intermittent production process and capital and labor intensive processes.

Activity: 5

Describe in writing about extractive, analytical, fabrication, synthetic and assembly processes, and the contribution of mechanization in improving production processes.

Trends in Production Enterprises

For many years in the past, all goods that were used by human beings were made by manual labor. Gradually, mechanization replaced the human labor with machines. Mechanization is the use of machines to do work previously done by people. It has greatly reduced the number of workers needed to produce a given amount of goods. At the same time, it has greatly increased the amount of capital needed for equipment. Mechanization had an impact everywhere. The pages of books like these, for example, were once sewn together by hand. Mechanization, therefore, replaced those hands with a binding machine and, as a consequence, dramatically increased the number of books published. Similarly, in transportation, the mighty locomotive engine replaced the collective labor of thousands of people and animals.

A modern extension of mechanization is automation. Automation is the process of performing a mechanical operation with either the minimum of human intervention or complete automatic control. Automation is a collection of methods for controlling machinery and production processes by automatic means usually with electronic equipment. In automated production, people are necessary to put the machines into operation and sometimes to monitor or regulate them and inspect their output. Moreover, the machines are automatic and they run by themselves.

An increasingly popular form of automation is robotics. This is the use of mechanical devices that duplicate the motion of the human hand. They are especially good for dirty, dull, repetitive, and, precise works. A robot is nothing more than a computer-controlled machine, which can be programmed to perform various production tasks. The distinctive part of the robot is its "hand" or "gripper", and the arm, which can-make human like movements. The first applications of robots were on hot, dirty, or heavy work, which was not well suited to human-so use of robots has subsequently been expanded into a variety of production jobs, including welding, painting, fixed assembly work and materials handling. While the use of robots can sometimes be justified by reduction of direct labor, they provide many more benefits, including flexibility to redesign parts, 24 - hour operation, performance of hazardous tasks, and more uniform quality. Robots are not mechanical people; they are part of an integrated production process.

Figure 1-9 Robots

1.3.2 Distribution Enterprises

When markets were small, producers used to sell their products directly to final consumers. As markets grew in size and in number the distance between the producers and consumers increased. As a result, a system of middlemen evolved between producers and the final consumers. Distribution enterprises are business enterprises involved in moving goods from their point of production to their point of consumption. The distribution enterprises fall into two major categories.

(i) Intermediaries

(ii) Physical distribution

1.3.2.1 Intermediaries

Intermediaries are business enterprises that serve as a link between producers and consumers and perform the marketing functions of distributing, storing and selling of goods in return for discounts from producer or potential profit from mark ups when they resale goods. The intermediaries perform an indispensable service for today's businesses. For example if the manufacturer of shoes in Addis Ababa wants to sell his/her products all over the country by owning his/her own outlets; the manufacturer probably could not profitably sell the products individually. The solution to this problem for the manufacturer is to sell to intermediaries.

Depending on the business functions, intermediaries are classified as follows:

a) Retailer
b) Wholesaler
c) Agents
d) Brokers

The intermediaries that consumers know best are retailers. A retailer is an intermediary that directly sells the products to consumers. **A retailer** is a seller who deals directly with consumers. Our neighborhood grocery is a retailer. The baker, druggist, the service stations where you buy gasoline for the family are some of the retailers that you encounter on daily basis.

In some cases, retailers do obtain their merchandises directly from those that make or grow them. For example, when retailers buy farm products from farmers. A **wholesaler** is a business firm that buys goods in large quantity from different manufacturers and re-sale them in smaller lots. One wholesaler, for example, might purchase one thousand jackets from one or more manufacturers and sell them in turn to several retailers. Most wholesalers specialize; that is, they handle just one line of merchandise, such as food, clothing or drugs.

Now imagine a large farm enterprise that could supply ten or more retailers with fruits and vegetables. Rather than taking time to find many retailers who are willing to buy the products, the enterprise sells the entire crop to a wholesaler. Then it becomes the wholesaler's job to find retail groups who will buy the farmer's fruits and vegetables. In this situation, the wholesaler simplified the marketing job that will be performed by the manufacturers.

Agents are firms that act on behalf of the manufacturers. They are business enterprises that do not actually purchase the goods they sell. Agents do not take title to good; they perform mainly a distributive and market development functions. The ownership of the products remains to the manufacturers but agents sell the products and receive a commission for the services they rendered. For example, Ambo Mineral Water Factory has agents in different regions.

Brokers bring buyers and sellers together and assist in negotiation. The parties hiring them pay brokers. They neither carry inventory, get involved in financing nor assume risk of operating a business. Their main function is to aid in buying and selling and for these services they earn a commission.

Distribution Channels

Distribution Channel, also known as a trade channel or marketing channel, is the sequence of business enterprises through which a product passes on its way from producer to the final buyer.

The number of channel levels involved can describe channel of distribution. Each layer of middlemen that perform some work in bringing the product and its ownership closer to the final buyer is a channel level.

The most common channel for distributing consumer goods is the traditional path from manufacturer to wholesaler to retailers and then to consumers. This is called indirect distribution because intermediaries move the goods to consumer not the producer. Some companies use direct distribution channels, selling their products to ultimate buyers without the involvement of intermediaries. For example, when a bakery directly sel1 the bread to the buyers, it will be a direct distribution. In direct distribution, the consumer directly buys the goods from the producer. In this instance there is no intermediary involved between the producer and the consumer.

The processes by which goods make their way from producer to consumer are described with the following diagrams.

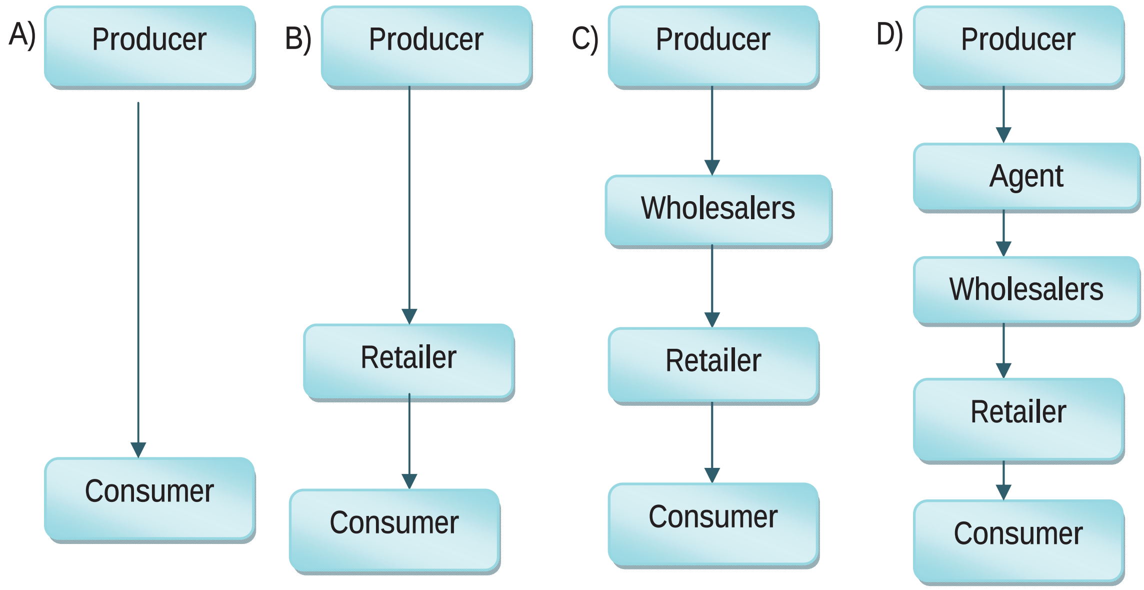

Figure 1-10 Distribution Channels

In diagram 'A' shown above, consumers directly buy products from the producer. For example, when you buy bread directly from a bakery, it takes the form of the distribution channel shown in diagram' A'; that means there is no intermediary involved. In diagram 'B', one intermediary, the retailer is in between the consumers and the producers. Such instance occurs when the merchants buy cereals from farmers and directly sell to consumers. As shown in diagram 'C, two intermediaries, the wholesalers and retailers are involved. In this case wholesalers buy in large quantity from producers and resale it to retailers and the retailers sell to the consumers. Most of the goods that we consume take this channel. In diagram 'D', an agent is involved in addition to intermediaries described in channel "C". For example soft drink companies have agents in different regions. The agent sells to the wholesalers, the wholesalers sell to retailers and retailers to final consumers.

1.3.2.2 Physical Distribution

Whatever channels a manufacturer chooses, there is still a decision to be made about how to actually place the goods physically at a place where they are needed and in proper condition without delay. The distributor must resolve the practical but sometimes difficult questions of choosing the appropriate mode of distribution, i.e. appropriate physical distribution decision.

Physical distribution encompasses all the activities required to move products physically by carrying them from the producer to the consumer. Physical distribution is concerned with the movement of goods from the place they are produced (from the producer) to the place they are to be consumed (the consumer). In doing so there are a variety of options to transport the products.

? Distinguish between channel of distribution and physical distribution.

The main meanses of transportations are grouped as the following:-

a) Road transport
b) Rail road's
c) Air transportation
d) Water transportation
e) Pipeline

A) Road transports: are the most frequently used forms of transportation. Road transport includes animal transport such as mules, donkeys and horses and transportation on vehicles such as trucks and buses. Domestic animals like donkey, horses, mules and camels are widely used in Ethiopia to transport goods and/or people from place to place. Road transport had advantages of other mode of transportation for two reasons.

i) They are good to offer door-to-door delivery from the manufacturer to the customer without intermediate unloading

ii) They operate on public high ways that do not require an expensive terminal or right off way as airlines and railroads do.

The main drawback of trucks is that they cannot carry all types of cargo.

B) Railroad: involves the use of trains that carry larger amount of goods usually for long distance. They can carry heavier and more diversified cargoes. They can move long distances without interruption. But they have one major disadvantage: They can seldom deliver directly to the customer, but usually depend on trucking companies to make the final delivery to the final destination. For example, the main railway route in Ethiopia is the railway from Djibouti to Addis Ababa. The Addis Ababa -Djibouti railroad covers a distance of 784 Km.

Figure 1.11 Rail Transport

C) *Airplanes:* are the fastest forms of transportation. Planes can carry only certain types of cargo because of size and shape limitations. Furthermore, planes are the least dependable and most expensive forms of transportation. But despite its limitations, air transport has become absolutely essential for certain industries. Speedy air shipment sometimes saves overall distribution costs by reducing the need for storage and insurance. The most popular organization, which works on air transport in Ethiopia, is *the Ethiopian Airlines* founded in 1946 G.C. EAL gives both domestic and international services.

Figure 1.12 Air Transport

D) *Water transportation:* water transport involves the use of ship of various kinds to transport goods from place to place. Water transport is the cheapest form of transportation. Thus, it is widely used for such low-cost bulk items as oil, coal, ore and cotton. However, some of the disadvantage of shipping makes it unsuitable for most businesses. Ships are slow, and service to any given location is infrequent. Furthermore, another form of transportation is usually needed to complete delivery. For example, to transport products from port of Djibouti to Addis Ababa requires either trucks or air transport. Shipment by water is not a common practice in many parts of Ethiopia because there is no as such a well developed and convenient water transportation or the rivers are not used for water transportation. However, in some parts of the country, rivers like *Omo* river and *lake Tana* are in use for water transportation.

Figure 1-13 Water transportation

E) Pipelines: *are* used almost exclusively to transport liquids and gases, and are of little use to manufacturers of other types of goods. Pipelines do provide dependable, continuous delivery for oil and natural gas. For example, a pipeline can be used to transport oil deposits from Sudan to Ethiopia.

Figure 1.14 Pipe lines

State the advantages and disadvantages of the mode of transportations.

1.3.3 Service Enterprises

Service enterprises are firms that provide services without creating or distributing goods. The communication industries, including the press, radio and television, the telecommunications systems are examples of service industry. Services to individual consumers include repair and maintenance, hotels and restaurants, barbers and hairdressers, private educators, doctors and hospitals. Financial institutions such as banks and insurance companies also provide services and are classified as service enterprises. Service firms can be classified as follows:

a) Business services
b) Personal services
c) Repair shops
d) Entertainment and recreation services
e) Hotels

a. Business Services

Are firms that render service to other business organizations. Examples include accounting firms, advertising agencies, public relation counselors, private employment agencies, blue print services, management consultants, etc.

b. Personal Services

In the personal services group are found barber and beauty shops, shoeshine, laundries, photographic studios, travel agencies, private colleges, etc.

c. Repair Services

Include automobile repair, shoe repair, furniture repair, electrical repair, black smith shops, etc.

d. Entertainment and Recreation Services

Are businesses that offer entertainment and recreations. These include gymnasiums, swimming pools, theaters and cinema, orchestras and the like.

e. Hotels

Hotels are firms that provide food, drinks and pension services. Hotels are large establishments compared to most of the other groups in Ethiopia.

Service industries vary greatly. The government sector offers services through legal courts, employment agencies, hospitals, loan agencies, military services, police and fire departments, postal service, regulatory agencies and schools. A large part of business enterprises also *offers* services through banks, hotels, insurance companies, consulting firms, medical and law practices, entertainment companies, real estate firms, advertising and research agencies. Some service businesses are large. There are also thousands of small service providers.

One of the major ways a service firm can differentiate itself is by delivering consistently higher quality service than its competitors do. The service providers need to identify the expectations of target customers concerning service quality. Unfortunately, service quality is harder to define and judge than product quality. Whatever the level of service provided, it is important that the service provider clearly defines and communicates that level so that its employees know what they must deliver and customers know what they will get. Unlike manufacturers who can adjust their machinery and inputs until everything is prefect, service quality always vary depending on the interactions between employees and customers.

1.4. Business Environment

? Can you define an environment? How it relates to business operations?

The nature of the interaction between a business and its environment will be easier to understand if the concept of a system is examined. A system is a group of related parts that work together in an organized way for some specific purpose or purposes. An Individual business firm is a system. It has related parts: management, production workers, machinery and the physical plant. The parts are organized into a system so that they can work together to convert resources into valuable end products.

Just as the production department is a working part of an individual business firm, the individual firm is itself a working part of an industry. **An industry** is viewed as a collection of related businesses that all work together to supply the total demand for a particular kind of good or service. For example, a small shoe manufacturing firm produces particular types of shoes. In turn, all shoe manufacturers work together to supply shoes to the market for shoes using common materials and methods, exploiting new research findings, supporting suppliers and selling to the same general market. They also influence one another through competition, quality, price setting, etc. Based on our example, a small shoe manufacturer is an individual firm where as all shoe manufacturing firms collectively are called the shoe industry.

A business environment is the collection of factors outside and inside the business system that influence the activities of business. The environment determines what a business can do and as such has a shaping and channeling influence on its development. Business environment also influences business enterprise decisions and ultimately the internal structure and process of business organization**.** Business environments interact with and influence business at every level.

Business environments are classified as **internal** and **external** environment.

The internal business environments

The internal business environments consists the following elements.

i. The market
ii. Suppliers
iii. Marketing intermediaries

The external business environments

The external (macro) business environments are composed of forces outside and beyond the immediate control of the business firm. It includes the following forces.

I. Economic environment
II. Legal environments
III. Socio-cultural environment
IV. Physical environment
V. Technological environment.

The impacts of these environments on business are discussed as follows:

I. The Economic Environment

The economic environment sets the basic rules by which a business operates. The economic environment consists of factors that affect a consumer's purchasing power and spending patterns. The economic environment affects the way firms and the whole economy use resources. The economic environment can and does change rapidly. The effects can be far reaching and require challenges in business activities. Even a well-planned business firm may fail if the country goes through a rapid business decline.

The three aspects of the economic environment of business enterprises deserving special consideration are: The global economy, the business cycle, and the economic system

a. The Global Economy

Though the economic environment varies from one country to another, economies around the world are linked and are very much interdependent. The changes in one country's economy affect the economy of others. One reason for this is that the amount of international trade is increasing.

A change in the exchange rate-the worth of one country's money in terms of another country's money- has a great impact on international trade. Business enterprises are not safe from the forces of changes in exchange rate just because their firms are not involved in foreign trade. New competition arises in a domestic market, as foreign products gain a competitive edge with lower prices.

Changes in price and quantity of some products would affect the activities of the entire businesses existing in a given country. For example, the change in price and quantity supply of petroleum products would affect the whole businesses of a country. When the price of petroleum products increases the price that would be charged by business enterprises for their goods and services also increases because they use oil products as a major source of energy. Hence, the global economic environment has a direct impact on the activities of national or local business enterprises.

b. Business Cycle

The term **business cycle** (or **economic cycle**) refers to economy-wide **fluctuations** in production or economic activity over several months or years. These fluctuations occur around a long-term growth trend, and typically involve shifts over time between periods of relatively rapid economic growth, and periods of relative stagnation or decline (contraction). These fluctuations are often measured using the growth rate of **real gross domestic product (RGDP)**. Despite being termed **cycles,** most of these fluctuations in economic activity do not follow a mechanical or predictable periodic pattern.

A business cycle consists of four unique components, each reflecting differing levels of economic activity and the subsequent circumstances occurring during each respective stage. An **expansion** or **recovery** is where the economy is experiencing positive and increasing economic output. Employment tends to increase (unemployment falls) and there is upward pressure placed on prices (inflation rises) as output rises. A **peak** or **boom** is reached when the economy has produced the greatest amount of output. At this point employment is generally at or near its highest level (unemployment is at its lowest level: usually below the full employment rate of approximately 5%) and prices tend to rise more rapidly (inflation accelerates). Following the peak is a **recession,** or **contraction**. During this phase output actually decreases (the rate of growth becomes negative); unemployment begins to rise and the inflationary pressure on prices fades. The low point of the cycle occurs next. This is known as a **trough** or **depressions** and unemployment tends to be at its peak and production at it low point. There is very little upward pressure on prices and in some cases there is downward pressure on prices (deflation).

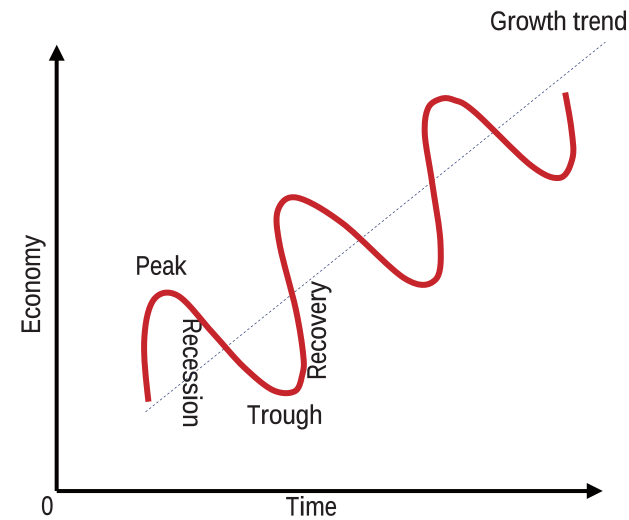

Figure 1.15 Business cycle

c. The Economic System

The economic system includes the basic economic rules that a given country follows in order to operate the business activities. In Ethiopia, the economic setting is guided by free market economic system. Businesses function in an environment where entrepreneurs are free to risk capital with the hope of creating profits and where a free market has the ultimate control over business decisions. One distinguishing mark of a free market economic system is that it permits individuals to own property of almost any kind. Anything owned by an individual is a private property.

When people are free to choose their own lines of business, some business persons make similar choices. This naturally leads to competition. Enterprises producing similar goods or services for their customer compete with one another in some way. One way is to sell at a lower price. This is known as price competition; the producer who charges more than the competitors may be at a disadvantage. This kind of competition benefits consumers as it holds prices down.

Producers also engage in product competition. That is, each producer tries to make its products better than competing products so that it can get much profit. This kind of rivalry encourages producers to improve their existing products, develop new ones and improve their production system through the use of better technologies. For the consumer, of course, this means not only better goods and services, but also a greater variety as well.

Unlike the prevailing free market system, Ethiopia was governed by command economy system almost for two decades. In this type of economic system, the government controlled the majority of the economic activities. The major production and distribution industries were owned and operated by the government. Government assigned officials directly manage some or all of the extraction of raw materials, manufacturing, communications and transportation. Government also plays a heavy regulative role in all other business activities. Even if limited amount of private profit was available to small businesses, most of the profit centers in government hands through heavy taxation. State planners make decisions centrally about what goods and services will be available rather than by the free play of market forces. Such economic system does not encourage entrepreneurs the desire to risk their capital in order to generate profit. However, the free-market system as is described above encourages entrepreneurs to risk their capital to own businesses.

Activity: 6

- **Discuss the impact of economic environment on business operations.**

II. Legal Environment

? Can you identify some of the laws governing business operations?

The legal environment is shaped by the interaction between businesses and government. The legal environments are the constraints on decision making that result from the legal and otherwise governing parameters within which the firm must operate. For example, the Federal and Regional governments would set laws that govern how business undertakings operate. Well-conceived regulations can encourage competition and ensure fair markets for goods and services. Thus, governments develop public policy to guide commerce, sets law and regulation that limit business for the good of society as a whole. Almost every business activity is subject to a wide range of laws and regulations.

Legislation affecting business has increased steadily over the years. Legislations have been enacted for a number of reasons. The first is to ensure the existence of free and fair competition among companies. By so doing, companies are protected from each other. Although business executives may praise competition, they sometimes try to neutralize it when it threatens them. So laws are passed to define and prevent unfair competition. The second purpose of government regulation is to protect consumers from unfair business practices. Some firms, if left alone would make poor products, deceive the public in their advertising, packaging and pricing.

The third purpose of government regulation is to protect the interest of society against unrestrained business behavior. Profitable business activity does not always create a better quality of life. Regulation arises to ensure that firms take responsibility for the social costs of their production or products.

➢ Business Law

Business law is concerned with any segment of the legal system that provides for a smooth and orderly flow of business transactions and the settlement of any disputes that may arise over these transactions.

Any business, large or small, faces the possibility of being on the initiating or receiving end of a lawsuit or some other legal action. Some useful laws that people in business should be aware of are: the law of contract, law of sales, the law of agency, the law of negotiable instruments, the law of warrants and product liability, the law of trademarks, copy rights and patents, and the law of bankruptcy.

Law of contracts: A contract is a voluntary agreement between two or more parties to do or not to do something. Contracts are basic to business operations because practically every business transaction involves agreements between people. For a valid contract to exist, the following requirements must be met:

1. ***Voluntary agreement:*** A contract must be voluntary where there is a mutual consent between the parties. The buyer without being forced must accept a genuine offer unconditionally.
2. ***Competent contracting parties:*** Contracts with parties who are under legal age, insane, seriously intoxicated, or otherwise unable to understand the nature of the transaction are typically unenforceable.
3. ***Legal act:*** The subject of the agreement must not be in conflict with public policy, such as a contract to sell an illegal product.
4. ***Consideration:*** Something of value, or consideration, must be received by the seller in exchange of what it gave to the buyer.

5. ***Form of contract:*** Contracts may be written or oral. Some contracts must be in written form to be enforceable. The existence of an oral contract must be demonstrated in some way; otherwise it may prove difficult to establish.

Law of Sales: Governments protect private property. Property may be real property, possessions with a long-term attachment such as buildings, personal property such as automobiles, machinery and furniture.

An important aspect of protecting property ownership is defining the terms and procedures by which control passes from one owner to another. Real property may be transferred by deed or lease. A deed actually transfers ownership to a new owner. In this case a buyer buys a property such as cars or mules on cash or on credit basis but has a full right on the property for an indefinite period of time. A lease gives temporary control of real property. This is an instance where the buyer leases land for specified period of time. The control would only exist on the time span stated on the agreement.

Law of Agency: An agent is a person or company authorized to carry out business and enter into agreements on behalf of another person or company called the principal. This relationship exists when executives, purchasing agents, sales representatives, and others act on behalf of their employing company. For example, your school principal acts on behalf of the Ministry of Education that assigned him/her to manage the schools affairs. An agent may also be an outside third party especially skilled at handling certain kinds of business activities. Lawyers often act as agents. The agent is obliged to work for the benefit of the principal and to follow his or her instructions while the principal is required to compensate the agent for his or her performance.

? State the conditions for a legally binding contract between a buyer and seller.

Law of Negotiable instruments: Important legal financial contracts employ the use of negotiable instruments, which are written documents that states currency in business transactions. The best-known negotiable instruments are checks. The law specifies a negotiable instrument must have the characters in order to be transferable to a new owner, that is, to circulate much like cash. It must, for example, be written and properly signed. It must contain an unconditional promise to pay" either on demand or at a definite future date.

Law of Warranties and Product Liability: A warranty is a legal assurance that goods or services being sold have certain characteristics. An *express warranty* is a statement, often in writing, made by the seller that the property being sold is of a specified quality and type. Express warranties often state that the seller will repair any defects or replace the merchandise if defects are found. For example some companies offer a guarantee up to one year to give maintenance services when the buyer buys such products like radio, house furniture, equipment etc. An *implied warranty* accompanies most sales as a standard part of law, even when the seller does not actually express it. The main provisions of an implied warranty are that:

(a) The buyer is receiving ownership of the property and that the seller is authorized to sell and

(b) That the goods are what they were represented to be and can be used for their intended purpose.

For example when a buyer buys a trouser, he/she immediately receives the title of ownership over the product. When the seller packs the product, it should be a product on which both the parties are agreed upon. That is, it should be a trouser not other product.

The Law of Trademarks, Copyrights and Patents: As a consumer, all of us are exposed to trade marks daily. They are practically on every product we use. If you are turning the first page of the book you will find ©. This is a symbol for a copyright. When a producer invents new things he/she has a patent right.

By its legal definition, a trademark distinguishes goods supplied by a particular manufacturer or merchant from similar goods manufactured or sold by others. It helps consumers to choose between different products or services. For this reason, the entire law of trademarks depends upon how consumers perceive them. A trademark is any word, name, symbol or device used to distinguish the product of one manufacturer from those made by others. For example, Pepsi Cola or Miranda is trademark for Moha Soft Drinks Company.

When a trademark owner sues for infringement, two things are accomplished. First, the monetary interest of the trademark owner is protected from unfair competition. Second, the public is also protected from being deceived or misled.

Copyrights are somewhat similar to trade marks in that they provide a legal means of protecting one's ownership. Copyright protects property created by the mind. The most commonly eligible copy right properties are literary, musical and dramatic, pictorial, graphic, sculptures, and cartographic works, motion pictures and sound recordings. For example, Dr. Tilahun Gessese has a copy right over his musical works. This means, no one is allowed to sing or record and sell the musical works of Tilahun without his permission.

A copyright gives its owner the exclusive right to reproduce (copy), sell, or adapt the work he or she has created. For example Kibour Dr. Haddis Alemayehu has an exclusive right over his book- *Fiker Eskemekabir.* Patents protect the invention or discovery of a new and useful process, an article of manufacture, a machine, a chemical substance, or an improvement on any of these. Patents give the owners exclusive rights to make and sell a patented product or to use a patented process for a specific period of time usually not less than 5 years depending on the invention. For example, if a person produces a machine that was not known before (invention) he/she has a patent right over the new machinery for a period of time.

When other persons or companies produce or sell patented product or process with out permission, which is called *patent infringement*, they are violating the patent law and are sued for damages. Like copyright, no one is allowed to make and sell the invention without the consent of the inventor (the patent owner). However, to have a patent on a certain invention, a product must consist of an idea or process not known before. It must be a discovery as distinguished from mere mechanical skill or knowledge.

The Law of Bankruptcy: Bankruptcy laws are intended to protect as fully as possible both a company and person with no enough money to pay debts to creditors. Bankruptcy law is a legal procedure by which a court divides up the remaining assets of an insolvent person or company among the people and organizations to which money is owed. Bankruptcy law is a way of protecting someone who is in severe financial distress because of debt to get a new start.

When bankruptcy law is declared, nearly all of the assets of the owner are eventually sold for cash. The proceeds are used to pay court costs and other costs, unpaid employee wages up to a maximum limit of each worker, taxes and secured loans. If any money is left after these charges, it is divided among creditors proportional to the total debt each is owed. The creditors then have no further claims.

? **Distinguish between trademarks, patent and copyright with examples.**

III. The Socio-Cultural Environment

? What is your culture? How does it affect your shopping habit?

The socio-cultural environment is made up of institutions and other forces that affect society's basic values, perceptions, preferences, and behaviors. People grew up in a particular society that shapes their basic beliefs and values. They absorb a worldview that defines their relationships to themselves and others. All the activities of business enterprises are governed by socio-cultural environment. The products produced and the advertisements made by business enterprises should reflect the norms respected by the given society. The following socio-cultural characteristics can affect business enterprises' decision-making practices.

a. Cultural Values and Beliefs

People in a given society hold many beliefs and values. Their core beliefs and values have a high degree of persistence. *Core values and beliefs* are passed on from parents to children and are reinforced by schools, religious institutions, business and government. For example, getting married could be an example of core belief for the Ethiopian society. *Secondary values and beliefs* are more open to change. Believing in marriage is a core belief; believing that people should get married early in life is a secondary belief. Business enterprises have some chances of changing secondary values, but little chance of changing core values.

Although core values are fairly persistent, cultural swings do take place through time. Consider the impact of popular music groups, movie personalities, and other celebrities on young people's hair styling, clothing and other norms. Business enterprises should predict cultural shifts in order to spot new opportunities or threats. Opportunities are circumstances that favor businesses organizations to grow. For example, conducive business policies could be an example for opportunities. Threats are also external forces but have a negative impact on the activity of the business. For example war between countries could be a threat for business organizations.

b. People's Views

People vary in their emphasis on serving themselves and serving others. Some people seek personal pleasure, fun and change. Others seek self-realization through religion, recreation or the pursuit of careers or other life goals. People use goods and services as a means of self-expression and buy products that match their personal view.

People also vary in their attitudes toward corporations, government agencies, trade unions, universities and organizations. By and large, people are willing to work for or want to develop business type relationships with reputable organizations. This suggests that business enterprises need to find ways to win consumers' confidence. They need to carefully assess their advertising communications to make sure that their messages are honest. Also, they need to review their various activities, policies, and regulations to make sure that they are doing their job as "good corporate citizens". Business enterprises should strive to build positive image through good public relations. People's orientation to consumption patterns, level of savings and attitude toward the market place affects the activities of business enterprises.

Business polices should reflect the need to consider the interests of consumers and of society as well as those of businesses. If the business enterprises ignore the values, which are respected by the society, they cannot survive for longer period. Business enterprise owners should be keen enough to identify the basic values and beliefs of the society they are operating and sense the cultural shifts that are taking place and adjust their operations accordingly.

Off course, some beliefs and values adopted by a certain cultural group may be contrary to the belief of the business owners. Business owners and managers must use tact and imagination in handing such cultural differences.

Activity: 7

- **Discuss the impact of cultural environment on business operation.**

IV. Physical Environment

? Can you identify the impact of physical environment on business operations?

The interdependence of a business and its various environments is further demonstrated by its relationship with the physical natural environment. The physical environment of business involves the relationship of business with nature. It is linked with natural resources like minerals, source of energy, climate, ecology, etc that are needed as inputs by business enterprises or that are affected by their activities.

Many of the resources used to create products come from the physical environment: From the land and the sea. The use and preservation of these resources is a legitimate concern of any economic system, of a government, and of the entire society. Business enterprises should be aware of three trends in the physical environment:

a) Shortage of raw materials
b) Energy supply
c) Environmental pollution

a) Shortages of Raw Materials: Minerals, fresh air and water may seem to be infinite resources. However, this is not the case. Water shortage is already a big problem in some parts of Ethiopia. Renewable resources such as forests are not found as they were in the past. Deforestation has caused shortage of timber-raw material for wood products- and degradation of the soil and once fertile lands have been changed to deserts. Companies in a forestry business are required to reforest in order to protect the soil and to ensure enough wood supplies to meet future demand. Food supply is a major problem. In order to overcome the shortage of food supply business enterprises engaged in food processing business must find alternative natural resources rather than merely relying on rainwater which is not dependable at all. For example, irrigation and improved farming systems are one among many ways to overcome shortage of food supply.

Nonrenewable resources, such as oil, iron ore, and salt have recently posed a serious problem. These natural resources are dwindling in time as a result of which firms making products that require these increasingly scarce resources face substantial cost increases to extract the materials. Business organizations are forced to engage in research and development and in exploration for new sources of materials to survive.

b) Energy supply: All production requires energy. Manufacturing, transportation, farming, mining, communications, and other business activities are impossible without a reliable source of power. Over the years, energy in Ethiopia has become more and more dependent on petroleum products like oil and natural gas. Having to rely on oil produced in other countries is a serious problem for the country's development. Obviously we need to reduce our dependence on foreign supply. While the energy shortage is a severe challenge, it can also be seen as an ample opportunity for businesses to supply an enormous market for alternative energy sources. These alternatives have to be found, so capital should be risked to search oil and natural gas all over the country. The effort to make use of solar energy as an alternative source of energy is an example of the initiative of business organizations.

c) Environmental Pollution: The effort to solve the shortage of energy and raw materials has to be evaluated in terms of its potential effect on the environment. It is true to say that business enterprises have caused damage to natural environments. Consider the disposal of chemical wastes in the soil and food supply and the littering of the environment with plastics and other packaging materials. The toxic elements that came out from heavy industries, automobiles, aircrafts, etc have greatly contributed towards air pollution. Efforts to safeguard the environment should therefore be one of the responsibilities of business enterprises.

Not all-environmental pollution is caused by businesses. Municipal organizations with inadequate sewerage treatment and trash disposal systems, inadequate sanitation programs, etc can also be mentioned as causes of environmental pollution. However, it has become important to consider all of the possible results of business decisions on the ecology. Ecology is the science that studies the interaction between living organisms and their environment. Ecologists view the natural world as a complex, interrelated system in which the actions and behavior of every part affect every other part. Business enterprises must review the consequences of their actions on ecology and take appropriate measures to preserve it for better life.

V. Technological Environment

Technology is defined as all the tools and ideas available for extending the natural, physical and mental reach of humankind. Technology is the application of organized knowledge to create new and better things, identify and solve problems in our society. The technological environment is the most dynamic force that shapes the destiny of business enterprises. Every new technology replaces an older technology. For example, computers replaced typewriters. When old business enterprises ignore new technologies, their existence will be threatened, as they cannot compete in the market. New technologies create new markets and opportunities. Technology comes into being through the innovation process- the systematic development and practical application of a new idea. A great deal of time-consuming work is necessary to develop a new idea into marketable goods or services. A better understanding of the innovation process can help to improve business enterprise chances of turning new ideas into profitable goods and services.

The innovation process has three steps. The first step is the conceptualization step when a new idea comes in the mind of someone. Development of a working prototype is the second step called product technology. This involves actually creating a product that will work as intended. The third and final step is developing a production process to create a profitable quantity-quality-price relationship. This third step is labeled as production technology. Successful innovation depends on the right combination of new ideas, product technology and production technology. A missing or deficient step can ruin the innovation process.

In the age of increased global competition for technology leadership, pressure on business enterprises to provide society with innovative goods and services will remain high.

The Internal Business Environments

The internal environment consists of forces that are part of an organization's marketing process but are external to the organization. These micro environmental forces include the organization's customers, its producer-suppliers, its marketing intermediaries and competitors. The organization is capable of exerting more influence over these than forces in the macro environment (External environment).

The internal (micro) business environment includes the following.

1. Customers

Organizations closely monitor their customer markets in order to adjust to changing tastes and preferences. A customer is people or organizations with wants to satisfy, money to spend, and the willingness to spend it. Each target customer has distinct needs, which need to be monitored. It is imperative for an organization to know their customers, how to reach them and when customers' needs change in order to adjust its marketing efforts accordingly. The market is the focal point for all customer decisions in an organization.

2.Suppliers

Suppliers are organizations and individuals that provide the resources needed to produce goods and services. They are critical to an organization's marketing success and an important link in its value delivery system.

3. Marketing Intermediaries

Like suppliers, marketing intermediaries are an important part of the system used to deliver value to customers. Marketing intermediaries are independent organizations that aid in the flow of products from the marketing organization to its markets. The intermediaries between an organization and its markets constitute a channel of distribution. These include middlemen (wholesalers and retailers who buy and resell merchandise). Physical distribution firms help the organization to stock and move products from their points of origin to their destinations. Warehouses store and protect the goods before they move to the next destination. Marketing service agencies help the organization target and promote its products and include marketing research firms, advertising agencies, and media firms. Financial intermediaries help finance transactions and insure against risks and include banks, credit unions, and insurance companies.

Summary

- Business is defined as all the activities that satisfies the needs and wants by providing goods and services for profit to maintain and improve our quality of life.
- A human need is a state of felt deprivation. Human beings have many complex needs. These include basic physical needs like food, clothing and shelter, social needs for belonging and affections and individual needs for knowledge and self-expression.
- Human wants are the form taken to satisfy human needs that are shaped by culture, attitudes and personality.
- Human needs and wants are unlimited but resources are limited.
- Goods are material objects, which have a physical substance. Goods are classified as producer goods and consumer goods. Consumer goods are bought and used by individuals and families without any further processing. Producer goods are used to make other products or are consumed in the general operations of a business or institution.
- The primary goal of business is to make profit. The desire of making private profit and of creating more personal wealth is the main reason why businesses are started and continue to operate.
- Business in addition to providing goods and services also serves as agents of exchange, sources of income, agents of social-cultural interaction, agents of technological advancement and sources of employment. As such it has made trade possible, increased quality of life, bring people with diversified background to work together and accelerated improvements in technology.
- The many functions of business and the endless possibilities for carrying out the process have resulted in diversity of businesses. Business enterprises are classified as production (manufacturing), distribution and service enterprises. Production enterprises include extractive processes, analytical processes, fabrication processes, synthetic processes and assembly processes. Distribution enterprises are business enterprises involved in moving goods from the point of production to the point of consumption. The distribution enterprises are intermediaries (channel of distribution) and transporation firms. Service enterprises can be classified as business services, personal services, repair services, entertainment and recreation services and hotels.
- The business environment is the collection of internal and external business system which is relatively controllable and uncontrollable. The internal business environments include the customer, suppliers and market intermediates. These are relatively controllable. The external business environment includes the economic, legal, socio, cultural, physical and technological factors. The ways in which a firm operates and adjusts its business are highly influenced by these factors. So business organizations should sense these business environmental factors that are taking place and should adjust their business strategies of operations accordingly.

Review questions

Part I. Choose the best answer from the given alternatives.

1. Goods and services are
   a) outputs of business enterprises
   b) means to satisfy needs and wants
   c) basic needs to be satisfied
   d) all except choice c

2. The need for food, shelter and clothing are called__________.
   a) basic needs c) individual needs
   b) social needs d) none of the above

3. Which one of the following is true?
   a) human wants are limited but resource are unlimited
   b) human wants are unlimited but resources are limited
   c) business satisfies needs but not wants
   d) business satisfies wants but not needs

4. One of the following is not a feature of convenience goods
   a) widely available c) purchased frequently
   b) relatively low prices d) requires extensive effort

5. The growth, stagnation and fall of the economy in a period of time is
   a) business transaction c) business cycle
   b) exchange d) global economy

6. What are basic forces that move a person to do something?
   a) Wants c) Demands
   b) Needs d) Goods

7. Which of the following is a producer goods consumed in the operation of manufacturing process?
   a) Capital item c) Supplies
   b) Raw materials d) Component parts

8. In hospitals service value exists only when the patient is there. This statement describes:
   a) Service perishablity c) service intangibility
   b) Service variability d) service inseparability

9. Which type of the tax levied on sale of goods or services?
   a) Payroll tax c) Consumption tax
   b) Corporate income tax d) Income tax

10. A collection of related businesses that all work together to supply the total demand for a particular kind of goods or services is called ________
    a) Environment
    b) Industry
    c) Hotels
    d) Market

Part II. Define the following key terms

a) Services
b) Trade channel
c) Physical distribution
d) System
e) Depression

Part III. Answer the following questions briefly.

a) Describe how business enhances quality of life.
b) State the features of a free market economic system.
c) Describe how the physical environment and business influence each other.

Unit 2

TYPE AND FORMS OF BUSINESS OWNERSHIP

Unit Outcomes:

After studying this unit, you will be able to:

- list the three common forms of business ownership.
- define each form of ownership.
- explain the advantages and disadvantages of each type of ownership.
- provide a rationale for the choice of ownership.
- make a distinction among the different forms of business ownership.
- identify and explain other alternative forms of business ownership.

Introduction

The world has experienced three economic systems: Free market, Socialist and Mixed economic systems. Free market economy is defined as an *economy in which businesses are allowed to operate without central government planning*. In this type of economy, nearly all businesses and private citizens own properties, either individually or in a group. Private ownership of properties is the basic requirement in a free market economy.

In unit two how a business gets started is explained. The unit also outlines the various legal forms of business ownership. The most common forms of private business ownerships are sole proprietorship, partnership and corporation. Their advantages and disadvantages are discussed. The factors that influence the choice of ownership and the less common forms of business ownership will also be dealt with.

Contents of the unit

In order to achieve the above objectives you will deal with the following topics:

- Common forms of business ownership
- Other forms of ownership
- Choice of ownership form

2.1. Common Forms of Business Ownership

? Identify and group businesses in their forms of business ownership. Then compare your answer with the next paragraphs.

Business can be owned in different forms, each with its advantages and disadvantages. However, the most common forms of business ownership are:

1. ***Sole proprietorship***
2. ***Partnership***
3. ***Corporation***

2.1.1. Sole Proprietorship

Definition: A sole proprietorship is a form of business ownership in which a single individual assumes the risk of operating a business, owns its assets, and controls and uses any profits that are generated. The word sole indicates that the business is started and run by one individual.

As it is defined above, sole proprietorship is a business carried on by an individual acting in an independent way. The business operation will be treated as personal assets and liabilities of the owner. The owner is the ultimate employer and manager of the business.

The concept of sole proprietorship can be illustrated as follows: Let us assume that Ato Alemu Bekele owns and operates a retail grocery known as Alemu grocery: Ato Alemu as a sole proprietor started the grocery by investing Birr 15,000 in cash. He used his personal property, which is estimated to be birr 10,000 for business use. Ato Alemu has also borrowed 4,000 birr from a bank.

Assets		
Cash on hand	15,000	
Personal property	10,000	
Total Assets		25,000
Liabilities		
Loan from bank	4,000	
Total liabilities		4,000
Capital, Alemu Grocery		21,000

This simple financial transaction illustrates that Ato Alemu has started the business with his personal contribution and by borrowing some amount of money from a local bank. Anything of value owned by the business is called ***asset***. In this case, cash on hand and his personal property are assets. Anything of value that is owed is called a ***liability***. The bank loan can be an example of a liability. The 21,000 birr is simply the ***net worth*** or ***capital*** of the business. This shows the financial position of the business when it is started.

Even though Ato Alemu can easily start, operate and close his grocery, he is equally responsible to pay the liability. If the grocery fails to pay its debts and if its assets of the business are not enough to cover the liabilities, Ato Alemu's personal property can be used to meet (pay) his grocery's liabilities.

As we have seen from the above example in sole proprietorship one person assumes all risks and keeps all profits. In a sole proprietorship, the proprietor must accumulate enough capital to start and run a business. The source of capital can be the personal resources of the owner, loans secured by personal credit, or a combination of the two.

Sole proprietorship is also called proprietorship, individual enterprise, sole trader or individual proprietorship. The owner of such kind of business is called a ***proprietor.*** Ato Alemu is a proprietor according to our definition.

Although there are some large proprietorship, commonly proprietorship is the ownership form for small businesses. The owner may hire someone to manage the business, but more often, the owner is also the manger. Actually, the owner manger may find it necessary to make decisions personally rather than delegate them to others.

Activity: 1

- **Define sole proprietorships and name at least five businesses around your locality organized as sole proprietorships.**

Advantages of Sole Proprietorship

Many people start a business by themselves, with the hope of making high profits and others do so because they enjoy being self employed and proprietor.

Sole proprietorship has the following advantages:

a) ***Ease of formation and closing a business:*** It is easy to form a sole proprietorship because the legal formalities and procedures of starting the business are not complicated. Generally, a proprietorship is begun easily as long as the business undertakes a lawful activity for profit. Local governments easily give licenses for sole proprietorship. Individuals with limited resources can start independent business and get themselves self-employed. The cost of starting this type of business is usually very low. Government regulations on sole proprietorship are limited, and therefore, more freedom of action is possible. It is also easy to close-up a sole proprietorship. As long as debts and bills have been paid on the part of the proprietor, a proprietorship can be dissolved as easily as it was begun, merely with a decision to stop operations.

b) ***Complete ownership of all profit:*** The main motive for business activities is profit making. Sole proprietorship is the only form of business ownership in which rewards and efforts go hand in hand. Since the owner of a proprietorship assembles and controls all the assets used to start and run a business, he/she also has the right to all profits that may result from its operations. In other kinds of business organizations, for example in partnerships and corporations, the profits must be shared with others. All of the profits of a sloe proprietorship however, belong to the owner (sole proprietor). This gives a great incentive to the proprietor, to apply the best of his/her ability in running the business. Management skill and hard work are usually the direct causes of profit. The clear relationship between effort and reward is also a strong motivation for most proprietors.

c) ***Freedom of action and flexibility:*** In sole proprietorship all management control is usually in the hands of the sole proprietor. In matters of business dealings, the sole proprietor can take his/her own actions. He/she has no other person to argue with. A proprietorship is easy and flexible to run. Being his/her own master and having the simplest organization, the sole proprietor can change the whole policy of his/her business in a short time to take advantage of opportunities that might arise from different situations.

d) ***High credit standing:*** Banks and other lending institutions are often more willing to give credit to proprietorships than to corporations in which the owners are not personally liable for business debts. When settling the debts of creditors, not only the assets of the business but also the proprietors' personal assets, such as cars, houses, etc may be used. The debts are more likely to be paid because the proprietor's personal assets are available to business creditors. The credit standing of the sole proprietorship may be better than other forms of ownerships. Hence, the proprietor has a great incentive to find ways to satisfy business debts in order to protect his/her own personal assets.

e) ***Tax advantages:*** A sole proprietorship pays small amount of income tax than any other kind of organization. On the other hand, a corporation must pay taxes on its earnings, and then stockholders must pay taxes for the second time when the earnings are distributed to them. But a sole proprietor does not pay individual income tax when he/she uses all or part of the earnings of the sole proprietorship.

f) ***Personal relations with customers and employees:*** The size of the sole proprietorship is usually small. The sole proprietor enjoys the entire profits. Therefore, the proprietor attempts to maintain a close touch with customers and employees. Owner’s attention to customers results in increased sales, and direct supervision of employees result in cost reduction.

g) ***Business secrecy:*** In a sole proprietorship, it is easy to maintain business secrets. Any change the proprietor wants to make regarding business methods or policies, he/she can do it without the knowledge of others. If confidential information is a key to the success of the business, it is unlikely that its owner will leak this information to others. Maintaining business secrets is very important in competitive situations.

Disadvantage

Many of the factors that create the advantages of sole proprietorship also result in disadvantages. Before deciding that the sole proprietorship is the best business form to take, the following possible disadvantages should be considered:

a) ***Unlimited liability:*** All assets owned by the sole properties, (both business and personal assets) are subject to claims of business creditors. Despite the effort of the owners, many small businesses may be unable to continue profitably. In a proprietorship all of the asset of the owner, both those invested in the business and personal properties may be sold to settle debts owed to creditors.

b) ***Restrictions on size:*** Since the capital used in sole proprietorship is restricted to what a single person has or can borrow, the substantial amounts of resources needed for a large company are usually not available. In addition, a single manger is not normally capable of running a large business without the assistance of experts in management functions such as planning, organizing, controlling, leading. Because of the limitation on size, particularly because of lack of adequate capital, proprietorships are often unable to compete effectively with corporations or partnerships by hiring personnel with such management skills. The unlimited liability of the owner also restricts the ability of business to undertake large projects because the proprietor may be indifferent to risk losing both his/her business and personal assets.

c) ***Limited Life:*** Since a sole proprietorship exists through the efforts of a single person, the firm often is forced to shut down or discontinue its operations if the owner dies or becomes disabled. The assets of a proprietorship may often be sold to a new investor in case the owner dies. But the highly personalized relationship between the former owner and customers makes it difficult, in many cases, for a new owner to continue the business successfully.

Activity: 2

- **List the advantage and disadvantages of sole proprietorship.**
- **Give examples for each advantages and disadvantages of sole proprietorship based on businesses practices around your locality.**

2.1.2. Partnership

Definition: **A partnership is an association of two or more persons to carry on as co-owners of a business for profit.**

In partnerships, partners contribute their private capital, whether owned or borrowed, accept personal liability for all the debts of the business, and share the profits among themselves in some manner that is satisfactory to all involved. The contribution and share of the profits of each partner need not be equal.

Any kind of business can be operated as partnership: A super market, a restaurant a small manufacturing organization, groceries are examples. But partnerships are particularly common among businesses that provide professional services. Medical doctors, dentists, lawyers, accountants and other professional often use this form of ownership to take advantages of each other's expertise in various areas, and to contribute additional capital for their business.

From the example given above we can understand that in a partnership two or more persons join their assets, skills and other resources assuming all risks and sharing in profit or loss. Each of the owners of such form of business is called ***partners.*** Partner’s relationship is based on agreement, written or oral, that is both voluntary and legal called ***article of co-partnership***.

The articles of partnership shall be drawn up by the partners and contains the items that follow.

1. Date of contract and length of life of the agreement;
2. The name, address, and nationality of each partner;
3. Nature of business, location and name of firm;
4. The contribution of each partner, the method of contribution and value of contribution;
5. Distribution of profits and losses;
6. Duties of each partner and hours of personal services;
7. Limitation on withdrawal of funds from the business;
8. Provision for a fiscal year;
9. Method to be followed in case of withdrawal of a partner and liquidation of the partnership
10. Method to be followed to admit a new partner to partnership.

The articles of partnership of “Belay and Tilahun Super Market” are illustrated below:

Belay and Rahma Super Market Articles of Partnership

THIS CONTRACT, made and entered into on the 7th day of July (Hamle), year 2005/1997 by and between:

1. Ato Belay Bekele (Ethiopian; address: Addis Ababa, Wereda 10, Kebele 13, House No. ***)
2. W/ro Rahma Awol (Ethiopian; address: Addis Ababa, Wereda 3, Kebele 47, House No ***)

Witnesseth: That the said parties have this day formed partnership for the purpose of engaging in and conducting a super market business in the city of Addis Ababa under the following stipulations, which are part of this contract:

First: The said partnership is to continue for an indefinite period of time.

Second: The Business is to be conducted under the firm name of "Belay and Rahma Super Market" at Addis Ababa, Wereda 10, Kebele 11, House N0. ***

Third: The investments are as follows:

Ato Belay Bekele: Birr 23,000.00 after deducting a debt of Birr 4000 from the following assets:

- Cash	Birr 8,000.00
- Merchandise	14,000.00
- Furniture	5,000.00

W/ro Rahma Awol: Birr 23,000.00 after deducting a debt of Birr 3,000.00 from the following assets:

- Cash	Birr 13,000.00
- Merchandise	8,000.00
- Equipment	3,000.00
- Furniture	2,000.00

Fourth: Each partner is to devote his entire time and attention to the business and to engage in no other business enterprise without the written consent of the other partner.

Fifth: During the operation of this partnership, both partners have to serve as co-managers and make business decisions mutually.

Sixth: At the end of each annual fiscal period, the net income or the net loss of the partnership is to be shared equally.

Seventh: Neither partner is to withdraw assets in excess of birr 1,000.00 a month, any part of the assets invested, or assets in anticipation of net income to be earned, without the written consent of the other partner.

Eighth: In case of the death or the legal disability of either partner, the other partner is to continue the operations of the business until the close of the annual fiscal period on the following June 30. At the time, the continuing partner is to be given an option to buy the interest of the deceased or incapacitated partner at not more than 15% above the value of the deceased or incapacitated partner's proprietary interest as shown by the balance of his proprietorship account after the books are closed on June 30. It is agreed that this purchase price is to be paid one half in cash and the balance in four equal installments payable quarterly.

Ninth: An additional person may be admitted to the partnership only with the consent of both partners. All partners, including the newly admitted partner should sign a new contract.

Tenth: Upon liquidation of the partnership, for any reason, the assets of the partnership after the liabilities are paid, are to be divided in proportion to the balance of each partner's proprietorship account balance on that date.

In witness where of, the parties aforesaid have signed and affixed their seales on the day and year above written

Belay Bekele (seal) _ _ _ _ _ _ _ _ _ _

Rahma Awol ((seal) _ _ _ _ _ _ _ _ _ _

2.1.2.1 General Partnership

General partnership is an agreement between two or more persons who are eligible for entering into binding contracts. The partners contribute their private capital either owned or borrowed. These same partners are liable for all the debts of the business personally, jointly and severally. Profits are shared among partners in a manner that is satisfactory to all involved in the partnership. The contribution and share of the profits of each partner need not be equal.

In a general partnership, all partners have unlimited liability. In general partnership the partners individually and as a group, are equally liable for the business's debts, even if the partners must use their personal assets to satisfy them.

Advantages

The advantages of a general partnership are:

a) ***Ease of starting the business:*** Partnerships are not more difficult to establish than sole proprietorships. At most they require a written contract, called "articles of partnership" between the partners.

b) ***Good credit standing:*** The credit standing for a partnership generally is even better than a sole proprietorship, since all the personal and business assets of the partners may be liquidated to settle business debts.

c) ***Tax saving:*** Partnerships are taxed only as an organization. Individual incomes of partners from profit sharing of the partnerships are not taxed separately.

d) ***Large amount of capital:*** Although most partnerships have few members, multiple ownership still provides considerably expanded financial resources when compared to a sole proprietorship. The personal wealth and credit of all the partners may be pooled to provide the capital need of a large operation or for a firmer financial base for a small business. The formation of a partnership often means less risk for each individual partner.

e) ***Diversity of management skills:*** Partnerships can provide wider range of business and management skills than sole proprietorships. Partners often have complementary abilities: One may be skilled in sales and marketing, another in financial management, another in production or services. This diversity can lead to a sounder business operation.

f) ***Opportunities for growth are better:*** More capital and management skill allows partnerships to grow more easily than most sole proprietorships. Expansion or the development of new products or services requires capital. Partners generally have more combined assets than a single individual. The diverse management skills available to partnerships permit a wider range and larger scale of business operations. The specialized employees that would be needed for a larger firm can often be attracted and kept in the organization by including them in the partnership agreement.

Disadvantages

Some of the disadvantages of partnerships are similar to those of a sole proprietorship:

a) ***Limited duration:*** If one of the partners dies or becomes unable to continue in the business, the partnership must be dissolved or changed in some way. Such uncertainty about the duration of a partnership may interfere with making long-term commitments.

b) ***Unlimited liability:*** The unlimited liability of each partner for the debts of the business is probably one of the disadvantages of this form of ownership. This can result in severe losses to one or more partners when the assets of other partners are not sufficient to pay their share of the debts.

c) ***Restricted growth potential:*** Even though a partnership has a greater capacity for growth than a sole proprietorship, it is also quite limited in the capital it can raise and the staff it can assemble compared to a corporation due to the following reasons: **i) Management conflict** and **ii) Difficulty of recovering investments.**

i. ***Management conflict:*** In a partnership, especially in small business, all partners often have equal authority. This division of authority can result in conflict when two or more of the partners disagree. These conflicts can become very severe and may result in the discontinuation of the business.

ii. ***Difficulty of recovering investments:*** Once an individual's resources are invested in a partnership, it is often difficult to recover the assets of the person who decides to withdraw, and it may be hard to find another buyer with the right combination of capital and skills. If a partnership is forced to dissolve because of the wish of a partner to do so, assets often must be sold below market value and loss results for everyone.

Activity: 3

1. **Identify the nature of general partnership.**
2. **What is "articles of a partnership"?**
3. **What are the advantages of partnership?**
4. **List the disadvantages of partnership.**

2.1.3 Corporation

A business may need more capital than could be provided by a sole proprietor or by two or more partners. Under these circumstances a third form of business organization called corporation may be used.

Ato Sultan and Ato Zeberga have a plan of organizing a big department store, like Tana Department Store. But they are unable to cope up with the capital, managerial skills and other resources needed of the intended organization.

Definition: A corporation is an association of individuals created under authority of law, which exists and has powers and liabilities independent of its members.

Ato Sultan and Ato Zeberga, together with three other investors, want to incorporate a department store.

Ato Sultan and Ato Zeberga with the other three investors (W/ro Chaltu Gemeda, Ato W/Mariam Kebede and W/t Gennet Teshome) took the responsibility of the initial organization of the corporation and provided the initial assets for the corporation. Persons who are responsible for the initial organization of a corporation and who provide the initial assets for a corporation are called **incorporates or promoters**.

The incorporates apply to the proper government agency (Ministry of Trade) requesting permission to form the corporation.

The articles of incorporation are illustrated with example shown below:
Edget Department Stores Corporation
Articles of Incorporation

First: The name of the corporation is Edget Department Stores Corporation

Second: The principal office of said corporation is located at Addis Ababa, Wereda 3 Keble 5, House Nº ***.

Third: The nature of the business, or objects, or purposes to be transacted, promoted, or carried on, is to engage in the business of selling different consumer goods and all business incidental to such sale.

Fourth: The total number of shares of stock that corporation shall have authority to issue is Ten Thousand (10,000) and the par value of each of such shares is five hundred birr (birr 500), amounting in the aggregate to five million birr (birr 5,000,000).

Fifth: The amount of capital with which the corporation will begin business is one million birr (birr 1,000,000).

Sixth: The names and places of residence of the incorporates are follows:

Ato Sultan Ali -- Addis Ababa, W 10, K 13, H. No ***
W/ro Chaltu Gemeda-- Addis Ababa, W 10, K 13, H. No ***
Ato Zeberga Dessu-- Addis Ababa, W 2 K 2, H. No. ***
W/t Gennet Teshome-- Addis Ababa, W 3, K 47, H. No ***
Ato W/Mariam Kebede--Addis Ababa, W 3, K 15, H. No ***

Seventh: The Corporation has to have perpetual existence

We, The Undersigned, being each of the incorporates here in before named for the purpose of forming a corporation to do business both within and without the city of Addis Ababa, according to Commercial code of Ethiopia and other related codes, do make this certificate, hereby declaring and certifying that facts herein stated are true and accordingly have signed and affixed seals this fifth day of March 10, year 2001.

In the presence of: ________________ (seal)
________________ ________________(seal)
________________ ________________ (seal)
Ministry of Trade ________________ (seal)

GIVEN under my hand and seal of office the day and year aforesaid

____
Authorized person

The predominant form of ownership for a large business is corporation. A corporation may be created for many purposes: Charitable, educational, governmental, and so forth. A business corporation, however, is organized for the purpose of providing goods and services for a profit.

A corporation is made up of and is owned by a group of people called **share** or **stockholders**. The ownership of a corporation is divided into transferable unit called share or stock. According to Ethiopian Investment Authority the establishment of corporation requires at least five persons and there is no maximum as to the number of share or stockholders. The owners share in the total investment and divide any profits that are made. The part of the profit that each share holder received is known as dividend. A corporation is created under the authority of law, and a charter must be obtained from federal or a state government before a business corporation can be formed. A corporation exists separate from its owners as legal entity. As such, it has certain rights granted by law. It may own and sell property, borrow money, manage its own affairs, enter into contracts and sue in court. Corporation is liable for the payment of its own debts. Individual owners are liable to the extent that they have invested money in the corporation, owners, thus have limited liability.

A corporation can be either a private limited or public limited depending upon its characteristics. The distinguishing feature of a private share company will have a limited number of share holders generally restricted to the members of the family. On the other hand a public limited company will have a large number of shareholders from different classes of the society.

Generally a share company may issue different types of shares with an intention to enlarge its capital. If a corporation issues only common stock, each share generally has equal rights. In order to appeal to a broader investment market, a corporation may provide for one or more classes of stock with various preferential rights. The preference usually relates to the right to share in distributions of earnings. Such stock is generally called preferred stock.

How is a corporation managed?

One way a corporation differs from both individual proprietorships and partnerships is in its management. The owners of individual proprietorships and partnerships usually manage their own enterprises. But in a corporation every stockholder is a part owner, and one corporation may have hundreds or thousands of stocks or shareholders. The shareholders' general meeting is the supreme managing body of the corporation. Each shareholder is allowed as many votes as he/she owns shares of stock. For example if one investor has 20 shares it means the investor has twenty votes. The shareholders' general meeting elects **the board of directors**. Board of directors manages the corporation. The general manager elected by board of directors governs the operation of the corporation or the day to day activity of the corporation. The Board of directors also decides how the profits shall be used. Corporations divide surplus profits among stockholders by paying dividends on shares of stock.

Promoters
↓
Share holders
↓
Board of Directors
↓
Management

- **Promoters** are those people who took the responsibility of the initial organization of the corporation and provided the initial assets for the corporation.
- **Share holders** are group of people who own the corporation.
- **Board of Directors** are elected by the general meeting of the share holders and are responsible to govern the operation of the corporation.
- **The management** is responsible to govern the day to day activity of the corporation.

Figure. 2.1 How a corporation is formed and managed

Advantages

Many advantages of the corporation arise from its multiple ownership and its existence separate from its owners. The main advantages are:

a) the ability to raise large amounts of capital
b) limited liability of the investors
c) continuous existence
d) ease of investing and withdrawing investment
e) specialized management

A corporation has the capability of raising the tremendous amounts of capital needed for large manufacturing, transportation, finance, construction, etc. enterprises. Corporations can accumulate capital by selling shares (stocks). Assets of large corporations amount to hundred millions of birr; neither the proprietorship nor partnership has been able to raise such amount of money. The limited liability offered by the corporate organization attracts large numbers of investors than sole proprietorship or partnership can attract. If a person invests birr 10,000 in a corporation's stock, he or she would lose only that 10,000 birr. If the corporation is dissolved, personal assets other than the amount invested are not risked.

Another feature of the corporation that has made it the predominant kind of ownership of a large firm is its ability to survive independent of any particular investors or mangers. Even if the owner of a significant number of stock holders die or wish to withdraw, his or her portion of ownership can usually be easily sold on the market, and the business activities of the corporation continue for long periods of time. The fact that portions of ownership in the form of stock can be traded in the open market like any other commodity is an advantage in itself. This makes it easy for investors to acquire partial ownership and withdraw from the corporation when they wish.

Corporations can provide the company with adequate and diverse management. The company is free to hire any employee. It can afford to pay good salary and wages and is thus able to get specialized professional skills needed for sound management

Disadvantages

The main disadvantages of corporations are:

a) generally high taxation
b) the complexity and high cost of its establishment and operation
c) legal restrictions on activities
d) relatively lower credit standing

Other less important disadvantages are:

i. Mangers of corporation do not have strong personal motivation that results from personal ownership and liability
ii. For companies with many stockholders, confidentiality of financial information becomes practically impossible to maintain. Of the greatest disadvantage of this form of ownership is that corporations are taxed more heavily than sole proprietorship or partnership. A corporation is separate legal entity; its earnings are taxed directly and at a relatively high rate. The same earnings are taxed again as personal income when they are distributed to stockholders.

The role of governments in authorizing the operations of corporations creates still other disadvantages: corporations are often expensive to establish and complex to run because of government regulations. Incorporation fees must be paid when the charter is secured. More government regulations apply to corporations than to any other form of ownership. Keeping record of the company's stock and its owner is another job that is not necessary in a sole proprietorship or partnership.

When the charter is granted for a new corporation, the kinds of business activities to be undertaken are specified. If the corporation wishes to engage in other activities, an amendment to the charter is required. Although this process is usually routine. It costs money in terms of management time and legal fees. The resulting delay sometimes interferes with the chance to take advantage of opportunities that might arise.

The limited liability of investors lowers the credit standing of the company. Lending institutions know that owners cannot be required to use their personal assets to settle the corporation's debts. If a sole proprietorship and a corporation of the same size apply for a bank loan the proprietorship would have a slight advantage over the corporation because of unlimited liability of the owner.

Activity: 4

1. **Who are incorporates?**
2. **Define articles of incorporation**
3. **Explain limited liability**
4. **What are the sources of many of the advantages of a corporation?**
5. **List the main advantages and disadvantages of a corporation.**

Advantages and Disadvantages of the three forms of business ownership

Advantages

Sole proprietorship	Partnership	Corporation
a) Ease of setting up, operating, and closing	a) Relatively easy to set up	a) Limited liability of investors.
b) Complete ownership of profits	b) Partners own the profit	b) Ease of investing and withdrawing investment.
c) Higher credit standing	c) Even higher credit standing than sole proprietorship	c) Ability to raise larger amounts of capital
d) Lower tax rate.	d) More capital is available than sole proprietorship	d) Survival almost assured
	e) Great diversity of operating skills	e) Specialized management
	f) Better prospects for growth	

Disadvantages

a) Unlimited liability for the owner b) Restricted growth potential c) Sickness or death of owner may mean end of business	a) Unlimited liability for the partners b) Restricted growth potential c) Sickness or death of partner my mean end of business d) Potential conflicts between partners	a) Generally higher taxation b) Complexity in starting up and in operating c) Legal restrictions on activities d) Lack of motivation toward company goals among its hired managers e) Loss of financial confidentiality in corporations that offer their securities to the general public

2.2. Other Forms of Business Owner Ships

While the main forms of business ownerships are sole proprietorship, general partnership, and corporation, there are numerous variations that may be used in certain instances. These variations are

1. Limited partnership
2. joint venture
3. joint stock company
4. cooperative
5. franchise
6. Licensing

Each form has advantages under certain circumstance.

2.2.1 Limited Partnership

Definition: Limited partnership is a form of business ownership in which one or more partners are granted limited liability, with at least one partner with unlimited liability.

The law makes it possible to establish a partnership in which one or more partners are granted limited liability, provided that there is always at least one partner with unlimited liability. This form of ownership is limited partnership. The partner or partners with limited liability are protected against losing more than the amount they have invested in the business because their personal assets cannot be seized for the settlement of the debts of the business. They are not, however, allowed to take an active part in managing the business. The main advantage of this type of ownership is that it allows the partnership to acquire capital from investors who do not wish to be active in the business.

2.2.2. Joint Venture

Definition: **A contractual agreement joining together two or more parties for the purpose of executing a particular business undertaking. All parties agree to share in profits and losses of the enterprise.**

A Joint Venture is different from ordinary general partnership in that it is formed for a particular purpose or venture. A partnership generally involves an ongoing, long term business relationship, whereas a joint venture is based on a single business transaction. This form of ownership is often used in real estate transactions and is sometimes the initial form of new corporations taken when they are first being set up. For example, if the partners, Ato Kebede and W/o Elsa, owners of a super market agree to operate their business for 5 years, 10 years, etc instead of for an indefinite period of time the partnership can be called joint venture.

2.2.3. Joint Stock Company

Definition: **Joint stock company is a partnership that is established by raising capital by selling portion of its ownership on the open market in the form of stock certificates.**

Partnerships may be established by raising capital through the sale of portions of ownership on open market in the form of stock certificate. Such organization is called a joint stock company. It combines features of a partnership and a corporation. Although this form of ownership is legal, it is seldom used today because stockholders have unlimited liability when it comes to the financial obligations of the company.

2.2.4 Cooperative

Definition: **Cooperative is a group of small producers of goods or consumers of goods and services that wish to band together to achieve competitive advantage of large size in the market.**

Small producers of goods or consumers of goods and services sometimes wish to band together to achieve the competitive advantage of large size market place. Such groups may form a cooperative in which production, marketing, or purchasing facilities are jointly owned and are operated mainly to provide a service to members, rather than to make a profit. Farmers, tailors, and other producers may form marketing cooperatives. Consumer cooperatives attempt to achieve lower prices by buying in quantity and by eliminating the profit in the final selling of goods. In a cooperative, any profit made is usually distributed to members as a rebate (refund of part of the original investment). Members of a cooperative usually have one equal vote in running its affairs, no matter what share of ownership they have.

? Identify the cooperatives that you are familiarized within your locality.

2.2.5. Franchise

Definition: Franchise is a licensing arrangement that permits an individual to own his or her business while benefiting from the use of the trademark, know-how, and reputation of an established firm.

The individual owner of the business who uses the trademark, know-how, and reputation of established firm is called the **franchisee**. The parent company allowing the franchisee to use its trademark, know-how and reputation is called **franchiser**. The franchisee pays the parent company (the franchiser) a royalty from part of the business's profit.

The franchise offers persons who are relatively inexperienced in a particular field, a chance to own and operate a business. In effect, it is a form of sole proprietorship. The franchiser provides the franchisee with a facility, operating advice, and marketing support. In return, the franchisee can be expected to make an initial cash outlay of an agreed upon amount. A good example of franchise in Ethiopia is Oil companies and filling stations throughout the country. For example, Total Ethiopia Ltd. (franchiser) allows large number Total filling stations (franchisees) to use its trade mark, know-how and reputation in their retail filling station business.

? List the different types of franchising business that are acquainted with in your locality.

2.2.6 Licensing

License may be granted by a party ("licensor") as an element of an agreement between those parties. A license is "an authorization (by the licensor) to use the licensed material (by the licensee). A licensing agreement is a written contract under which the owner of a copyright, know how, patent, service mark, trademark, or other intellectual property, allows a licensee to use, make or sell copies of the original. Such agreements usually limit the scope of field of the licenses and specify whether the licensee will pay royalties or some other consideration in exchange. While licensing agreements are mainly used in commercialization or a technology, they also used by franchiser to promote sales of goods and services.

Activity: 5

1. **List the three factors that influence the choice of business ownership form.**
2. **What are other forms of business ownerships?**
3. **Make a distinction between general partnership and limited partnership.**
4. **Explain the difference between joint venture and joint stock company.**
5. **Give examples of cooperatives from your locality.**

2.3. Choice of Ownership Form

There are three factors that influence choice of ownership form. Each of the three kinds of ownership has important advantages and disadvantages, and no form is ideal for all businesses. The special characteristic of each form however, usually makes one form more suitable than another for a given business enterprise. Fortunately, the form of ownership can usually be changed as needed.

The major factors to be considered in choosing a form of ownership are:

1. The nature of business
2. The financial effect on operations
3. The attitude of the owners

2.3.1. Nature of the Business

The size of the business and the kind of goods and services it provides will influence the form of ownership. The features of sole proprietorship are generally best suited to small businesses, while one of the main advantages of corporation is that it can provide the resources and management needed for a large company. Sole proprietorships are more common in business with local markets, while corporations are suited to regional or nationwide operations. If the form of ownership chosen is corporation, the business will always be subject to more government regulations than proprietorships or partnerships.

2.3.2. Financial Effects of Operations

The amount of funds needed by a business is one of the most important factors in choosing a form of ownership. A sole proprietorship is limited to the resources of the owners and partnerships are limited to the resources of its partners. Corporations however, can assemble large amounts of capital from many different investors. The degree of risk and the extent of liability that the owners are willing to accept will affect the choice of form of ownership. A corporation usually has less tax advantage. The division of profits is usually quite simple in a corporation since earnings are distributed based on the number of shares owned. Some partnerships require complex earning distribution schemes to allow for the varying contributions and portions of ownership held by partners.

2.3.3. Attitudes of Owners

The number of owners involved in a business venture has an obvious effect on the form of ownership. Often, an entrepreneur may wish to have complete control of operations and may be unwilling to share profits. Where there are multiple owners, other factors must be considered. If continuing operations are to be established, one that will outlast its founders, a corporation is the most suitable. If the owners wish to retain a high degree of direct control over the operations of the business, a partnership will more often offer this than would a corporation. A partnership also generally gives owners more equal participation in management. Corporate organization typically limits the authority of individuals to specific areas.

? Discuss the three common form of business ownership in relation to the factors to be considered in choosing the ownership form.

Summary

- Most of the business facilities and resources are privately owned in free market economy. The ownership may take a number of legal forms. The most common forms of business ownership are:
  a) sole proprietorship
  b) general partnership
  c) corporations
- In a proprietorship, assets and profits are owned by one individual who has unlimited liability for the legal and financial obligations of the business.

  In a general partnership, assets and profits are owned by two or more persons who has unlimited liability for business debts

  Stockholders own the assets and share the profits of a corporation. Their risk and liability are limited to the amount of their investment.

  The three common forms of business ownership have their own advantages and disadvantages.
- The choice of the best type of ownership for a business is based on:
  a) nature of the business
  b) the financial effects on operations
  c) the attitudes of owners
- In addition to the three common forms of ownership, there are six alternative forms which can provide special solutions for business problems and needs. These alternatives forms include: Limited partnership, joint venture, joint stock company, cooperative, Franchise and Licensing.

Review questions

Part I. Choose the best answer from the given alternatives.

1. What is the term that describes anything of value owned by the business?
   a) Assets c) Capital
   b) Liabilities d) Ownership
2. A group of people that ask a corporation is called ______________.
   a) Share holders c) Incorpaters
   b) Stock holders d) a and b
3. What is a partnership that is established by raising capital by selling portion of its ownership in the open market?
   a) Cooperative force c) Join stock company
   b) Limited partnership d) Joint venture
4. Which group are responsible for running of enterprise?
   a) Promoters c) In capitals
   b) Shareholders d) Board of directors
5. What is the term that describes refund as part of the original investment?
   a) Franchise c) Fund
   b) Rebate d. Profit

Part II. Answer the following questions briefly.

1. List the most common types of business ownerships.
2. What are the three major factors that influence choice of business ownership?
3. What are the three major alternative forms of business ownership?
4. Define the following terms:
   a) Sole proprietorship b) Partnerships c) Corporation
5. What are the advantages of sole proprietorship?
6. What are the disadvantages of partnerships?
7. List the main disadvantages of corporation
8. What is the difference between unlimited and limited liability?
   a) Which of the three main forms of ownerships have limited liability?
   b) Which have unlimited liability?
9. In what ways are partnerships advantageous over proprietorship?
10. How is a limited partnership differ from a general partnership?
11. How is a joint venture differ from a general partnership?

12. Why do small producers sometimes form cooperatives?
13. Define franchise and give example of companies in your locality

Part III. Case Study

Ato Ayalew Zewdu and W/ro Tsige Getachew dreamed opening a restaurant. Just a little place, a dozen of tables etc, but with great food décor. Ato Ayalew and W/ro Tsige actually did open their small restaurant in the town of Awassa after three months of hard work.

Setting up a restaurant is an expensive undertaking. As investor they had spent birr 70,000, most of it borrowed. Rent in Awassa is high, a kitchen had to be built and restaurant appliances and fixtures are costly. Table and chairs, dishes and ashtrays had to be purchased. Menus had to be printed. Foodstuff, soft drinks and liquor had to be purchased.

Given these difficulties, it is fortunate that Ato Ayalew and W/ro Tsige had some restaurant experience before they launched their venture. Ato Ayalew had worked in three different restaurants as a waiter and W/ro Tsige had worked in several restaurants as a restaurant manager.

Based on the information given above answer the following questions

1. What are the advantages of running a restaurant choosing partnership as a form of ownership? The disadvantages?
2. Do you think starting the restaurant would have been easier if there had been more partners? Why or why not?
3. How might Ato Ayalew and W/ro Tsige resolve disagreements so as to preserve their partnership?
4. If Ato Ayalew and W/ro Tsige wanted to form a corporation (restaurant) would you advise them to do so? Explain your answer.

Unit 3

FINANCING BUSINESS ORGANIZATIONS

Unit Outcomes:

After studying this unit, you will be able to:

- define money and explain its functions.
- identify the source of capital for investment.
- describe the role and functions of financial institutions.
- describe how business firms reduce risks.
- examine the financial and investment policies of Ethiopia.

Introduction

Businesses need funds for running their operations. The acquisition of properties owned by a business, periodic payment of debts, salaries, expenses, etc all require adequate amount of money in the organization. The specific use to which money will be put partly determines the best source for the money.

Unit three focuses on analyzing the financial needs of businesses and describes where and how funds are obtained. These financing needs which include both long term and short term funding can be met either by personal contributions of owners, selling a share in the ownership or by borrowing mainly from banks. Money and its importance and banking system are also covered as sub-topics of the unit. The ways in which businesses can reduce their financial risks are also explored in this unit. Finally, investment related topics pertaining to the current practices of Ethiopia are also included in the unit.

Contents of the unit

In order to achieve the above objectives, the following topics are included:

- Money and its importance
- Source of capital for investment
- Banking system
- Risk and Insurance
- Investment policies in Ethiopia

3.1 Money and Its Importance

? Can you explain some of the uses of money for personal and business operations?

The use of money as a medium of exchange was developed early in most societies. You remember that in barter system specific kinds of goods and services are directly exchanged for other goods or services. Later on, the barter system was gradually replaced by the use of money and money has become the universal medium of exchange. As such, the use of money has many advantages over that of the barter system.

Money is indispensable to our production and exchange systems. All economic activity is measured, guided and facilitated by money. People receive money in exchange for their services, for raw materials to make products available, or for the use of productive equipment that they supply directly or indirectly. By circuitous routes people return the money to society as they spend it for the things they want. In an unceasing process, the money circulates from producers to consumers and back to producers.

Definition: Money is anything that people will accept in exchange for their goods and services in the belief that they may in turn exchange it for other goods and services.

In primitive societies, whatever material proves easiest to store, transport and exchange may be used as money in "monetary transactions". In any society, people may use anything they wish for money if the material being used has the same meaning to all of them. All sorts of things like various metals, gold, salt and etc. have been used as money. Later on paper money came into being replacing metallic money. Our most important money today is in the form of bank deposits on which Cheques are drawn.

Irrespective of their nature and form, if gold, birr or bank deposits are regularly used and generally accepted as a means of payment, they are considered as money. The only common factor in all these payments is general acceptability based on limitation of supply relative to their demand. Such payments are not aspects of the barter system. For example, in a barter system a student may exchange a book for another book, but books are not generally accepted or used as a means of payment and hence are not money.

Any object can be used as money. But some objects serve well than others, of course. Salt bar served well during early times in Ethiopia because it was hard to come by with the technology of the times. Most societies have designed and produced their currency using substances that are fairly durable and relatively easy to divide and to carry around.

? What makes monetary transactions different from barter transaction?

3.1.1 Functions of Money

Society needs money for several purposes. No matter what types of money a country use, money performs the following universal functions. These are:

a) Standard of Value
b) Medium of Exchange
c) Store of Value
d) Standard of Deferred Payments

a) ***Money Serves as a Standard of Value:*** Money serves as a standard by which the worth of all goods and services is measured and stated. Without money the price of every good or service has to be expressed in terms of exchange ratios with all other goods or services. For example, we would need to know how many loaves of bread would be required to purchase a bottle of milk. These activities require an enormous information burden for both buyers and sellers because it is very difficult to compare the value of bread with the value of milk or the value of milk to the value of coffee, etc. In contrast, the existence of money as a common standard for expressing value permits us to express the prices of all goods and services in terms of monetary unit. For example, in Ethiopia the monetary unit is birr, in Kenya the monetary unit is shilling, in the United States of America the monetary unit is dollar. The prices of all other goods and services are expressed in multiples of the monetary unit irrespective of form and origin of the goods or services. Money serves as a common denominator of measuring value. We express the value of all economic goods in terms of money and these monetary values are called prices. Such nature of money makes commerce easier because it serves as a common standard of value. The value of many different kinds of products can be expressed in a single standard as 2 meters of cloth may cost 50 birr and a box of nails may cost 15 birr, and etc.

Money is also a standard of value for accounting records. Since every thing bought and sold is stated in terms of money, it is possible to maintain accounting records and to make financial statements. It would be very difficult for businesspeople to know whether they were operating at a profit or loss if the only records they kept were in terms of physical inventory. A grocery, for example, could have little knowledge of the success of operations if he/she knew only that the store contained more bottles of soft drinks but fewer kg of coffee.

> **?** **What does money serve as standard of value means? Support your answer with examples.**

b) ***Money serves as medium of exchange:*** Money can be exchanged for any kinds of goods or services; it is valuable to everyone. This universal acceptability of money makes trade much easier. Money is also divisible. In a barter system axe might worth ten sacks of flour, but what will happen if the owner of the axe needs only one sack? While there is no way to divide an axe into ten parts, money can be divided into units as small as needed. This divisibility of money into "units of account" enables money to measure the relative value of things facilitating satisfactory exchanges.

> **?** **Which of the following is best used as a medium exchange? Paper or gold? Why?**

a) Money serves as a store of values: Money also provides a convenient means of storing value. A person's or a company's income does not always match current needs for buying goods and services. There may be excess income that may not be used immediately which needs to be kept for later use. A farmer may produce nearly all of the year's income at harvest season; the farm produce can be sold and thus converted to cash, which is kept for use for many years. Surplus income from a number of years can be accumulated for later use or for investment in enterprises requiring large amounts of capital. Such accumulation is difficult in a barter system.

There are many ways in which this function of money is helpful to society. Money as a store of value gives people a time option. People who are paid once a month are able to spread their expenditures evenly over the days of the month, spending their stored money as their needs require. People are able to put money aside for retirement, for the education of their children, for the purchase of a business, etc. They can defer their consumption as they choose, and they can accumulate funds for investment.

In the absence of money, one could accomplish the same thing by storing commodities. It would be much less convenient and quite expensive, however, to build up a store of meat, vegetables, clothing, gasoline and other goods for later use. Although other commodities besides money are stored for later use, money has the advantage over most of other commodities as it avoids deteriorating (loss of value) in storage. Off course, there may be shrinkage in the purchasing power of money or there may be an increase in the purchasing power of money. But the number of birr that was stored (kept for later use) will be the same as the number of birr later available. In addition, money is much durable as compared to perishable products and can easily be carried from place with little effort.

b) ***Money serves as a means of deferred payments:*** Money functions as a standard of deferred payments means individuals can purchase on credit such items like fuel, clothing, food items, etc and settle the amount at a later date. The importance of money as a standard of deferred payments is even greater in contracts covering a longer period of time. The average person enters into a contract to pay specified monthly amounts over a period of time for ten or fifteen years to as long as thirty years in constructing a house.

Activity:1

Discuss the universal functions of money with examples.

3.1.2 Characteristics of Money

? Can you identify the characteristics of money before reading the next section?

Some of the characteristics of money are:

1) Acceptability
2) Divisibility
3) Portability
4) Durability
5) Homogeneity

1. Acceptability

Money should be acceptable means that people should not hesitate to exchange their goods for money. Precious metals like gold and silver were widely used as money because such metals were in universal demand, that is, were generally acceptable. However, for money to have value and, therefore be acceptable, it must be limited in supply relative to demand and the productive capacity of the country irrespective of its forms.

2. Divisibility

The material used as money must be easily divided into denominations without loss of value. That is, the material must not lose its value as a result of its division. To make exchange as easy as possible, money must have the characteristic of being divided into small parts. For example one birr is divided into one cents, five cents, ten cents, twenty-five cents and fifty cents. Likewise, the paper notes are divided into one birr, five birr, ten birr, fifty birr and hundred birr. This way, money is also divisible into smaller denominations to facilitate exchange.

3. Durability

The material used as money should not be spoiled easily. It has to last for a long time. Some of the early forms of money such as corn, fish, skin, salt were unsuitable in this regard as they can be spoiled or damaged easily. For example when salt gets wet or when it is stored in a humid place, it dissolves. Metals such as gold and silver will last for many hundreds of years. The quality of the metal coins that we use for currency these days can stay for quite a long time without rusting.

4. Portability

Money must be easy to carry. Since it has to be moved from place to place, it must be possible for us to carry it from one place to another without difficulty or expense or inconvenience. Precious metals such as gold and silver may be relatively easy to carry. Even paper money is most ideal or convenient to carry.

5. Homogeneity

The material out of which coins are made or the paper out of which the paper notes are printed should be of the same quality. One coin or material should not be superior to another. Homogeneity of money is the basis for money to be universally acceptable and serve as a measure of value.

Discuss the characteristics of money in relation to the exchange processes that you observe around your locality.

3.1.3 Forms of Money in Ethiopia

Recorded history tells us that in Ethiopia, barter trade started to give way to primitive money beginning as far back as 525 A.D. The salt bar called "amole" was the primary article of exchange followed by pieces of cloth, iron bars, bracelets, gold and cartridge, etc. Later gold and other coins made of other types of metals were introduced. Every country has gone through the long history of using so many "odd" things as money. As trade expanded, metal coins outshined the other articles of exchange. Among such coins, the Maria Theresa dollar was very popular.

The Maria Therese dollar was introduced in 1751 in Austria during the reign of Queen Maria Theresa. It was an attractive silver coin that was very popular in the Middle East. It found its way to Ethiopia at the end of 18th or the beginning of the 19th century. The Maria Theresa dollar was so popular that the Austrians continued issuing it until 1858, long after the queen's death in 1789. In Ethiopia, the Maria Theresa dollar was used as a medium of exchange for a long period of time.

Figure 3.1 Maria Theresa dollar

Emperor Menelik made an effort to introduce the "Thaler" in 1894. Since then coins, paper money and other forms of money were in use as a medium of exchange in Ethiopia.

Figure 3.2 Emperor Menelik's currency first introduced in Ethiopia

Figure 3.3 A 500 dollar Bank Note issued in May 1914

Today we use three forms of money in Ethiopia: Cents, Paper Money and checking deposit (or demand deposits). When you think of money, you may consider cents and paper money you usually use as the only forms of money. These are called currencies. But the basic money supply also includes checking deposits or demand deposits, money kept in checking accounts in a bank. Cheques are considered to be money because they can be used like cash and exchanged immediately for goods and services. Demand deposits are claims against a bank, which can be transferred by means of cheques from one person to another. Checking deposits are so close to coins and paper money in immediate purchasing power, which makes them to be considered to be a form of money. The details on how the cheques will be issued and used will be discussed later in this chapter.

The coins issued are 1 cent, 5 cents, 10 cents, 25 cents, 50 cents and 1 Birr. Only the National Bank of Ethiopia issues cents.

Figure 3.4 Current Coins used in Ethiopia

Paper money is issued in terms of money notes. The paper money notes consist of 1 birr, 5 birr, 10 birr, 50 birr and 100 birr notes. These birr are legal tender, which means that they are accepted in payment of taxes and public debts in the country. No one has the right to reject the birr as far as they are in good conditions. It is the National bank of Ethiopia that issues the birr notes. The details of the role of the National bank of Ethiopia will be discussed later in this chapter.

Figure 3.5 Currently used Birr notes in Ethiopia

3.1.4. Money Supply

Demand deposits in banks plus currency make up money supply, that is, the total amount of money which could be spent for goods and services at any one time. Economists often are concerned with the question of what size of money supply is right for a certain level of economic activity. Too little money may slow down the smooth flow of economic activities and thus economic growth. Too much money relative to our needs and productive capacity may increase prices thus making life relatively difficult.

Individuals and organizations that want to use money as a means of exchange, storage of value and investment create the demand for money. The effect of money supply on the economy and the demand for it is complex. There are, however, two general effects that are widely recognized.

Firstly, if the demand for money remains constant and the supply of money increases, the prices of goods and services increase. One interpretation of this effect is that an increase in the money supply leads to more buying. These increase the demand for goods and services and thus increase their prices. This increase in price is called inflation.

Secondly, if the supply of money remains constant and demand increases, economic production decreases since businesses would not get additional money to invest in production. Limits on the supply of money reduce purchasing power and limit the total amount of goods and services that can be produced and sold. If this brings a drop in prices, it is called deflation.

? Could you identify the difference between inflation and deflation?

3.2 Source of Capital for Investment

In many parts of the country, people earn money by selling goods produced by other producers. The aspiring retailer cannot simply make available the products that he/she sells from someone's property. The retailer needs capital- money used to buy inputs, supplies, machines and machineries, etc to be used in production or merchandize to be sold to consumers. This is called investment. The capital-the money for investment- can come from a number of sources. For example, the retailer might have 1000 birr in cash to buy products for resale or he/she might take a loan from friends or family. Credit associations or local banks might provide loan to the retailer to operate the business with more capital. These simple transactions for starting retail business illustrate the alternative sources of fund available for investment. The alternative sources of capital for investment are **Equity financing (Owners' contributions)** and **Debt financing**.

3.2.1. Equity Financing

Most companies try to finance the operations of their enterprises at least in part by reinvesting profits from ongoing operation. This is a sound, stable method of financing for established companies. Most businesses, however, will be financed from outside source when they first begin operations, and most businesses need additional financing at certain points in their growth.

When funds are raised through the contribution of the owner, it is called equity financing. This can be done in various ways. In equity financing, funds are raised by selling a portion of ownership, or equity, in the business through selling stock to shareholders in the corporation or inviting new partner or owner in the case of a partnership. With this type of financing, the original owners of the business agree to share the ownership, risks, and profits of the firm with new owners or investors. The advantages and disadvantages of financing businesses through equity financing are discussed in the succeeding paragraphs.

The major advantages of equity financing are:

- Complete Ownership of Profits: Profits produced by a business financed by owners rather than by lenders belong to the owners and are not reduced by loan payments.
- Stable Operations: Businesses with a high proportion of equity financing are generally more stable. Business performance is less likely to be threatened by an inability to meet obligations to lenders.
- No interest charges must be paid: This is a particular advantage in an economic slump when sales and revenues may be reduced.

The major disadvantages of equity financing are:

- Capital needs of business vary over time. If requirements decrease, invested money may remain idle and does not produce income.
- A greater total investment by owners is required to maintain a given scope of operations, which limits scope of operations, when little or no borrowed money is used.
- The original owners sacrifice a portion of their control and profits.

? State the basic features of equity financing with examples from your locality.

3.2.2 Debt Financing

Debt financing is accomplished by borrowing funds. The business owner may borrow money (take loans) from credit associations, micro finance institutions, banks, individuals or other business organizations.

? Discuss the nature of debt financing. Name out financial institutions that you may encounter in your surroundings.

3.2.2.1. Credit Associations

One of the sources of loans for investors is credit association. A credit association is organized as a cooperative. It provides its members with a means of saving as well as borrowing money. Members save some percentage of their income on regular basis. These savings provide funds from which loans are made. A credit union lends only to its members. Like other cooperative organizations organized on voluntary basis, the members of credit associations are people with a common interest. They may be employees of the same firm, members of labor union or members of same kebeles.

For those who qualify for membership, credit associations may be the best sources for obtaining loans.

Characteristics of credit associations.

a) They lend only to members and rarely have to investigate loan applicants
b) Much of their work is done by members
c) Office space is sometimes provided free of charge by the businesses for which the members work.
d) Like all true cooperatives credit unions are non-profit organizations

3.2.2.2. Commercial Bank Loans

Banks make loans for businesses and individuals. Because banks lend other people's money, their credit requirements are very strict. Not everyone is able to meet these requirements. For those who do, however, banks are one of the best alternative sources of loans. Their charges are regulated by law and vary according to the type of loan, the method of payment and the total demand for money.

Bank loans are usually short-term loans because funds are available from the saving accounts of the customers and the customers should get their money when they request. Generally, the bank loans are classified as short term, middle term, over draft and long term loans.

a) A short-term loan: is usually re-paid within one-year limit. This type of loan is given for the businesspersons in order to meet their working capital needs. That is the fund, which is needed to cover expenses and other costs related to the operations of the business. Such loans usually paid on monthly, quarterly or the total payment could be made when the loan matures.

b) Middle term loan: usually due from one to five years time. In order to secure such loans the bankers usually request personal possessions like machinery, commercial vehicles, or production facilities as a collateral- property guaranty for the repayment of the loan. The repayment for the loans is usually based on the agreement between the banks and the borrowers. For example, Dashen bank has two to three years middle-term loans.

c) Over-drafts: This type of loan facility provides the users to withdraw more than the amount they kept in a checking account. The banks usually grant loans to specific customers to use up to a certain maximum limit. For example, the bank can offer a maximum limit of 55,000 birr for specified customer. In such circumstances, even though the customer only 20,000 birr in his/her checking account balance, he/she can withdraw money up to 55,000 birr. The bank will cover the remaining 35,000 birr considering that the borrower will deposit the amount in the mean time. The bank provides such loans for those customers of the banks with good cash flows, high growth potential, commitment of the management, and the manner in using bank cheques and other criteria.

d) Long-term loans: When funds are available, banks frequently make loans for a period of over five years. These are called long term loans. They often stipulate certain restrictions for the borrower such as requirement to get the lender's permission before assuming more debts. The most common long-term loan is a mortgage loan. This is a long term loan secured by giving some kind of valuable and tangible property such as buildings and equipment as collateral.

The advantages of borrowing funds are:

a. Borrowing is convenient for short-term needs. It makes it unnecessary to keep large amounts of cash for peak needs.
b. Borrowed money provides additional capital without giving up any ownership or control of the business.

c. Owners who are able to borrow money and make profits on it can enjoy the increased profits without increasing their investment.

However, debt financing has the following disadvantages.

a) Borrowing money is sometimes unavailable or can be obtained at high interest rates; companies that have come to rely on debt financing may encounter severe difficulties in this situation.
b) Companies that use borrowed money must meet interest payment regularly. This can be a burden or even impossibility when revenues are down or the company is facing other financial difficulties.

? Differentiate between the various sources of financing, types of loans with their advantages and disadvantages.

3.3. Bonds and Stocks

3.3.1 Bonds

A bond is another alternative way for obtaining investment money, usually long term, through borrowing. A bond is a written pledge to lenders stating the borrower's intention to repay a loan. A bond is a debt of the issuing corporation which matures at a stated future date and on which the corporation pays interest. A bond specifies

a) the amount of money that has been borrowed, which is called the principal
b) the date the principal will be repaid, or the maturity date, and
c) the rate of interest that will be paid periodically over the life of the bond.

If the company wishes to borrow a million birr, which will mature after two years, for example, it might issue a thousand bonds worth 1000 birr each at 12 percent. In return the investor receives a bond certificate that may promise to pay the bondholder 1,000 birr after two years plus 12 percent interest every year up to maturity. The bond certificate serves as an evidence for the lender. Accordingly, the principal of the bond is 1000 birr, the maturity date is 2 years and the rate of interest is 12%. The maturity value of the bond is computed as follows.

Principal	×	**Rate of Interest**	×	**Maturity date**	=	**Interest**
1,000	×	**12%**	×	**2 years**	=	**240 birr**

Principal + Interest = Maturity value

Thus, the maturity value of the bond will be 1000 + 240 = 1240 birr

? What makes bonds different form bank loans?

3.3.1.1 General Features of Bonds

All bonds issued have the general features described below:

a) Provision of Trustee
b) Various Denominations
c) Maturity Dates

a) Provision for Trustee

Bonds, which represent a debt of the issuing corporation, are usually held by a large number of investors. These investors may be widely scattered over the country and may need someone to safeguard their interests and act on their behalf in the action required. Such a person is known as a *trustee* and is chosen by the corporation at the time the bond is issued.

The duties of the trustee are included in the legal agreement under which the bonds are issued called the *indenture*. In the indenture, the trustee certifies that the bonds are genuine, holds any collateral that may be used as security for the issue, and collects money from the corporation to pay the interest and repay the principal. In addition to these specific duties, the trustee makes sure that all provisions of the indenture are carefully followed during the lifetime of the issues.

b) Various Denominations

Most bonds are issued in different denominations. The value of money printed on a bond is called its face value, or denomination. Sometimes the denominations of part of the bond issue will run higher, such as 5,000 birr, 10,000 birr and 50,000 birr or the denominations may be in lower amounts 500 birr or 100 birr. If bonds have a face value of less than 500 birr, they are frequently referred to as baby bonds.

c) Maturity Dates

Bonds must be repaid at some future date. The length of time between the issue and the repayment dates of the bond is called the maturity date. Usually the maturity date of the bonds varies. The maturity date could be 10 or more years.

3.3.1.2 Types of Corporate Bonds

Although there are many types of bonds available, three of them are commonly in use. They are: 1) Mortgage bonds 2) Debenture bonds 3) Convertible bonds

- ***Mortgage bonds:*** This is a bond secured by property owned by the issuer like buildings and other movable properties. Mortgage bonds are relatively safe investments because the collateral can be sold to settle the loan if the issuing company is unable to make payments.
- ***Debenture bonds:*** A debenture bond is an unsecured bond, and as such it has no lien against specific property as security for the obligation. In practice the use of debenture bonds depends on the nature of the borrowing firm's assets and its general credit worthiness. For issuing debenture bonds, the company does not need specific security. For this reason, their use is restricted to large, stable companies with long records of consistent earnings.
- ***Convertible Bonds:*** These are bonds that can be exchanged for common stock at a rate specified in the bond. A 1000 birr bond can be converted to ten shares having a price of 100 birr equally. For example if Ato Ahmed owns a bond priced 1000 birr, Ato Ahmed can take his money back at the time of maturity or can convert share of the bond issuing company so that he can become the share holder of the company. This provision makes bonds more attractive to many investors.

Governments also issue bonds. Governments use bonds for funds to build schools, libraries, electricity generation's plants and etc. The federal government issues bonds to finance its operation. The most popular is the government treasury bill. Such bonds will mature within specified period of time. Usually it has a short time of maturity.

? **Distinguish between the different types of bonds?**

3.3.2 Treasury Bill/T-Bill (Yegemjabet Sened)

A short-term debt obligation backed by the government with a maturity of less than one year. T-bills are sold in denominations such as in 1,000 birr up to a maximum purchase of billion birr and commonly have maturities 28 days, 91 days 182 days.

T-bills are issued through a competitive bidding process at a discount from par, which means that rather than paying fixed interest payments like conventional bonds, the appreciation of the bond provides the return to the holder.

3.3.3 Stocks or Shares

Stock or shares are units of ownership by which the amount invested by each owner in a corporation are stated. The certificate that the corporation issues when the investors contribute money or other assets in the corporation is called stocks or shares certificate. The stock or share certificate is an evidence of the investors' ownership equity. The people and organizations that own corporate stock usually own shares of the assets of the corporation. This is different from bondholders who have only lent money to the company. Bondholders, as lenders, do not have an ownership right.

Many stocks have a stated value assigned to them when they are issued. This stated value is called the par value of a share. When investors buy shares of a corporation, they are required to deposit money equal to the par value of the number of shares they buy. For example, the stated value of one share of Awash bank is 500 birr. If an investor invests birr 1,000,000 in Awash bank, he/she will have 2000 shares.

There are two types of stocks, namely *common stocks and preferred stocks*. The basic type of capital stock issued by every corporation often is called common stock. Common stocks possess the rights of ownership-voting rights, participation in dividends and a residual claim to assets in the event of liquidation. Corporations can also issue preferred stocks. The term preferred stems from the fact that these stocks almost have "preference" or priority over the common stock in receiving dividends and in the event of liquidation. However, preferred shares usually lack significant advantages found in common stock. For example, the dividends paid to preferred stocks normally do not increase if the company prospers. Also preferred stockholders usually do not have voting rights and therefore, have little say in management.

A corporation originally issues stock to raise capital needed to begin and to carry on operations. It sells stock to individual inventors or to other companies of financial institutors in return for cash to use in its operations. The first time the stock is sold is the only time the issuing company receives money from the stock.

Initial issues of stock are often sold in very large blocks to only a few buyers. These original buyers may then resell shares in smaller lots to other investors. Even though a single share of stock may be sold and resold hundreds of times during the life of a corporation, the issuing company does not normally take part in these transactions. Stock or shares are bought and sold through stockbrokers who simply inform the issuing corporation of the transaction and of the present owner. A stockbroker is a person or company that represents investors in the buying and selling of shares If an investor wishes to buy 100 share of stock, he or she will instruct a broker to make the purchase. In return for their services, brokers receive a commission on the size of the order.

Activity:2

1. **Form a group and select two business organizations in your locality. Interview the owners and write the advantage and disadvantage of financing through loan or equity.**
2. **Organize educational visit to finance offices and report on the concept of treasury bills.**

3.4 The Banking System

A bank is a business enterprise that deals with money and credit. A bank is a service enterprise. These services range from simple things like maintaining an information desk to complex things like financing the importing and exporting goods. The some number and kinds of services may not be available at every bank. Almost all banks offer the following three important services.

1. They accept and safeguard money deposit with them.
2. They transfer money payment made by cheque.
3. They make loans to individuals, businesses and governments.

3.4.1 Banks Accept Deposits and Safeguard Money

How often have you heard or read about people whose money has been lost, stolen or destroyed by fire? Keeping money in a bank can prevent individual and companies from such kind of tragedies. Banks provide guaranty for the safety of money kept in them. Money that is kept in a bank for safekeeping is called a deposit. When you put your money in a bank, you are a depositor. This does not mean that somewhere in the bank a package of money is stored away with your name on it. It simply means that the bank owes you a sum of money equal to the amount you deposited. In other words, your deposit is a debt of the bank. As depositor, you can also withdraw money whenever you want from the bank. This is called withdrawal. A withdrawal is the opposite of a deposit.

In order to know how much money each customer has on deposit, a bank keeps a careful record of deposits and withdrawals. A bank's record of a customer's deposit and withdrawals is an account. If you are a depositor at a bank, you have an account with the bank.

Sometimes a depositor wishes to deposit cash and leave it for a period of time to earn interest. An account with a bank on which the bank pays interest to the depositor is called a saving account. In this case, the money is not only safe, but also it earns interest. For example if Shegitu aims to deposit 1000 birr for two years in a saving account that earns simple interest at 3%, the interest would the computed as follows.

$$\textbf{Interest} = \textbf{Principal} \times \textbf{Rate} \times \textbf{Time}$$

$$60 = 1000 \times 3\% \times 2$$

Thus, Shegitu would earn an interest of 60 birr after two years. The sum of the money in the bank would be 1060. (1000 + 60 birr) at the end of two years. Rules and Regulation governing saving accounts of commercial Banks are as follows.

- Saving account may be opened on personal application and identification with initial deposit of birr fifty. A deposit should be made on the bank's official form provided for the purpose (deposit slip) and duly signed by the account holder. A deposit book (bank pass book) will be issued to the depositor after making the initial deposit. Subsequent deposits of birr one and up to any amount will be accepted.
- When deposits and withdrawals are made, the deposit book must be presented to the bank. Withdrawals should be made on the bank's official form provided for the purpose and duly signed by the account holder.
- Any amount in a savings account will attract interest at the rate of 3% but no interest will be paid on balances under birr 50. Only a fifty (50) birr deposits will earn interest. (Note that the rate of interest changes from time to time. It was 6% in the past but now the current interest rate in Ethiopia is 4 %)
- Interest will be calculated on the minimum balance standing to the credit of the deposit between the first days to the last of each Gregorian calendar month.

Advantages of keeping money in the saving accounts:

1. ***Safety:*** Money kept in a bank is safer than in any place.
2. ***Saving account earns interest:*** When money is deposited in a saving account it earns interest. Thus an individual with a saving account will get extra money by just keeping his/her money at the bank.

Activity:3

1. **List the possible services that may be rendered by banks for the community**
2. **Calculate the interest based on the following information**
   a) **Principal 20,000 Rate 5% Time 3½ Years**
   b) **Principal 13200 Rate 6% Time 5 Years**
   c) **Principal 5000 Rate 5½ % Time 3½ Years**
3. **Form a group consisting of 10 members and make an educational visit to nearby banks around your locality and report to the class the procedures required to save money in the saving accounts.**

3.4.2 Banks Transfer Money Payments Made by Cheque

Like the saving account, a checking account also provides protection against the loss or theft of money. The checking account is an agreement by which a customer deposits money in an account and is given a book of cheques so that money can be drawn against that account. Cheque is an order to a bank to release the amount of money specified.

The person who signs the cheque ordering the bank to pay cash from that person's account or the account of a business is called the *drawer*. The person or business to whom the bank is ordered to pay the cash is called the *payee*. The bank on which the cheque is drawn is called the *drawee.* Checking account offers the convenience of paying by cheque. Because money deposited in a checking account may be withdrawn any time wanted, checking accounts are called demand deposits. Banks are not allowed to pay interest on demand deposits. For that reason people deposit money in checking accounts that they plan to spend in the near future.

Figure 3.8 Sample of a Cheque

Like currency (cents and paper money), demand deposits also circulate. Ownership of these deposits is transferred from one person to another by means of cheques. A single bank may handle thousands of cheques that its depositors have written or received. Each bank must make payment for cheques drawn on funds deposited.

The use of checking account has the following advantages:

1. Checking accounts eliminate the need for keeping large amount of currency on hand. Thus the risk of misappropriation and exposure for damages and theft are minimized.
2. The owner of the business must notify the bank of the name of person/persons authorized to sign cheques. Thus, access to cash is limited to those individuals designated by the business owner or owners.
3. The signature of the cheque can easily be checked and readily identifies the person responsible for each cash disbursement.
4. The bank returns to the depositor all cheques that it has paid from the account. Thus, the depositor has documentary evidence showing the date and amount of each cash payment, the identity of the person receiving the money and the remaining balance.

? **Write the difference between saving account and checking accounts.**

3.4.3 Banks Make Credit to Individuals, Businesses and Government

Banks provide a variety of financial services to customers. They maintain saving accounts and pay interest on them. They facilitate safe payments through cheques. In addition to the above, banks also provide loans for financing business operations and satisfy financial needs of individuals and groups and in the process earn income in terms of interest. Most of the profits of commercial banks come from the interest earned by making loans to businesses and individuals. The nature of bank credit and related policies will be discussed in the succeeding paragraphs.

Credit refers to the act of obtaining something of value in return for re-payment at a definite or determinable future time. Credit policy is the action taken by the government through its central bank to regulate and control the supply of institutional credit.

Credit provision is a major function of banking. Commercial banks play an important role in credit provision and fasten the overall economic activity through the following functions.

- Mobilization of resources and unused deposits
- Rendering banking services to the public
- Advancing credit facilities to various economic sectors

3.4.3.1 Credit Management

Credit management refers to a system developed to provide, monitor, investigate and implement and follow up the supply of money loans including procedures and ways by which the loan is repaid. It makes use of credit investigation as a preliminary step in providing credit. Credit investigation is used to provide and verify vital information desirable in making a decision. It is also important to know when sufficient credit information is available relative to credit line.

Granting credit to a large extent depends upon the faith and trust which the banker places in a borrower. But, the borrower's ability to pay involves impersonal as well as personal factors. The personal factors may be described as the capacity of the borrower. The impersonal factor is the marketability of the customer's product. The primary factor of credit granting are based on five essential elements, called the 5 C's: They are:

a) Character
b) Capacity
c) Capital
d) Collateral
e) Confidence

a) *Character:* Character chiefly applies to groups of traits that have social significance and moral quality. It is thus the sum of mental and moral qualities in a person. Therefore, of all the elements of credit, character is the most dominant factor, because without it no person can be trusted regardless of the ability or property that may be possessed. Character is thus the basic element that needs an expert appraisal in granting credit.

In judging the moral risk involved in the application for credit, several elements must be investigated. The applicant's character can be judged based on the applicants background, associated life style, records for honesty, reputation for paying bills i.e. willingness and promptness in discharging obligation in unfair competition, trustfulness in advertising, civil court record, record of past performance and sufficient business and/or personality information.

? **Discuss some of the characters that should be possessed by the businessperson.**

b) ***Capacity:*** Capacity refers to income generating or earning power. It is important that adequacy of the applicant's income and present debt paying commitment as well as the applicants expenditure pattern be determined. Capacity is the test of the business risk. The business risk is an element, which depends upon the ability of the managers' of the concern. A person may be honest in everything, but if he/she is deficient in ability to pay; the banker may not grant the credit. The chief test of business risk is the capacity to generate profits over a period of time, which can be seen from the cash flow reported in a period of time.

Furthermore, the following must be observed in judging the customer's capacity.

Management ability: It refers to the ability of the managers to operate the day-today activities of the business. Such factors like one man business versus group management, modernization of systems and methods, know-how of handling financial matters, the existing applications of credit principles, degree of team work of official personnel, degree of human and employees relation are included in the management ability.

Business location: This refers to the place the business is located with reference to raw material and markets, modernization of equipment cost utilization system and the research system applied.

Demand stability: refers to the business's ability to attract customers on a regular basis.

Sales and net profits stability: refers to the business's ability to constantly generate profits as compared to the total sales on a constant basis without fluctuations on the activities.

c) ***Capital:*** In the sense of credit granting, capital measures the borrower's financial soundness or his/her financial strength. That means, the applicant must have enough money in his/her business to "turn around on". The owner's net investment in the firm must be considered when establishing credit limits. The main reason for having adequate capital is that receipts and expenditures are not synchronized and the enterprise has often to make payments before its claims are settled. Thus, the banker has to go for valuing the borrower's assets, which if converted into cash, would be sufficient to liquidate the requested loan.

The banker's first concern is thus to make sure that the borrower is able to repay the requested amount of money. Such ability depends upon elements such as:

a) The sufficiency of owner's equity funds in the business
b) The burden of repayments of existing debt
c) The cash inflow for the servicing needs of business and the ability to repay debt
d) The competence and reliability of management

The property risk can be determined by an examination of the borrower's financial statements. The lending bank should always determine whether the prospective customer had already borrowed from other financial institutions and how much. Capital adequacy could most rigorously be measured in the short term by contrasting shareholders fund. The property is always regarded as less important than the normal or business risk.

? **Discuss the difference between capacity and capital?**

d) Collateral: Collateral is anything of value (property or any other pledged deposits) pledged as additional security to secure the performance of a contract or the discharge of an obligation. Collateral security is returned to the customer when the obligation is fulfilled. For example, buildings or movable property like automobiles can be used as collateral to secure loan from the bank. Debtors may default on a debt either through fraud or negligence or due to the failure of the debtor's assets. To guard against such contingency, the creditor (the bank) may, as condition of the loan, require the borrower to assign legal rights over some specified asset of sufficient value to cover the amount of the debt.

e) Confidence: A bank lends to its client only if the bank has total confidence in the customer's intent and ability to repay the loan- the principal with interest. Confidence in the literal sense is an assurance of mind or firm belief in the trustworthiness of another person. Therefore, credit granting depends upon the level of confidence, which the bank places in the borrower. Such confidence results from the interplay of the four essential factors: Character, Capacity, Capital and Collateral.

? **Describe the 5'Cs with examples from banks in your localities.**

Brief History of Banking in Ethiopia

Modern banking in Ethiopia began in 1905, when the Bank of Abyssinia was first established in Addis Ababa under a 50-year franchise agreement with the then British owned National Bank of Egypt.

The agreement made between Emperor Menelik II and the representative of the National Bank of Egypt regarding the opening of the bank included:

1. A sum of pound sterling 500,000 was fixed to be the capital of the bank of which one-fifth was subscribed and the rest was to be obtained by selling shares in some important cities such as London, Paris and New York.
2. The bank was given the sole right of issuing bank notes and minting coins which were to be legal tender and freely exchangeable against gold and silver cover by the bank as well as to establish silver coins and abolish the Maria Theresa dollar.
3. The government agreed to give the bank a free grant of land and permit for building offices and warehouses.

Figure 3.9 Bank of Abyssinia

The building of Bank of Abyssinia is currently occupied by the Arada Post Office

4. All government and public funds were to be deposited with the bank and all payment to be made by cheques.
5. It was agreed not to allow any other bank to be established in Ethiopia during the 50-year concession period given to the institution.

After operating for about 25 years, the Imperial Government of Ethiopia nationalized the bank of Abyssinia. The new national institution, which bought the properties of the bank and took-over its operations was legally established on August 31, 1931 under the name of the "Bank of Ethiopia." Most of the board members of this new institution were Ethiopians. The Bank of Ethiopia, which was a purely Ethiopian institution or the first indigenous bank in Africa took over the commercial activities of the Bank of Abyssinia and was authorized to issue Ethiopian dollar notes and coins. Later, the bank opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harar as well as an agency in Gambella and a transit office in Djibouti. The Bank of Ethiopia operated until 1935 and ceased to function during the Fascist invasion. The Italians closed it in 1936. During the 5 years of enemy occupation, many branches of the Italian banks were opened and operated in the main towns of Ethiopia, but were closed soon after liberation.

The State Bank of Ethiopia was established on August 1942 and acted as the Central Bank of Ethiopia with the vested power to issue bank notes and coins as the agent of the Ministry of Finance.

Figure 3.10 State Bank of Ethiopia established in 1942

In July 1963, the new Ethiopian Monetary and Banking Law came into force and the State Bank was finally dissolved and split into the National Bank of Ethiopia and the Commercial Bank of Ethiopia. Share Company, thereby separating the functions of central and commercial banking. The central banking functions were transferred to the National Bank and the commercial activities to Commercial Bank for the purpose of encouraging the expansion and smooth running of banking and monetary operations in the country.

The National Bank of Ethiopia was assigned with the following responsibilities:

- Determining the amount of currency in circulation and the amount of loans to be advanced to the public

- Administering the country's foreign reserve currency.
- Licensing other banks within the country and controlling their activates.
- Issuing the national currency and seeing to it that it is circulated.
- Acting as an Agent of the Government, it deposits and pays Government money.
- Keeping the account of other government Agencies and Ministries.
- Preparing and selling Government bonds and documents.

To ensure the general economic stability of the nation, the National Bank controls other Banks in the following manner.

- Determines the loan relationships between other banks and financial institutions and itself
- Makes the necessary loan regulations of other banks and financial institutions.
- Determines the maximum and minimum interest rates to be imposed by other banks and financial institutions.

Figure 3.11 Head Office National Bank of Ethiopia

The National Bank is both a government bank and bankers' bank because this bank serves the banks themselves in almost the same way as the public. The National Bank of Ethiopia was established with a capital of ten million Ethiopian Dollars and is government owned led by a Management board. To protect the interest of depositors, banks are required to follow the rules and regulations of the National Bank of Ethiopia as a supervising authority of all banks and insurance companies in Ethiopia.

The Commercial Bank of Ethiopia was incorporated as a share company on December 16, 1963 to take over the commercial banking activities of the former State Bank of Ethiopia. The bank is wholly owned by the state and operated as an autonomous institution under the commercial code of Ethiopia. The following are some of the important responsibilities of the Commercial Bank of Ethiopia:

- Performing all commercial banking activities
- Encouraging the public to open up different accounts with banks.

- Encouraging the development of business activities through banks and familiarizing the public with the activities of commercial banking.

According to the general directives issued to it by the National Bank of Ethiopia, the Commercial Banks are responsible to perform the following duties.

- Receive savings, demand and time deposits
- Make loans and advances.
- Draw, accept, discount, buy and sell bill of exchange, drafts and promissory notes payable within or outside Ethiopia.
- Issue letter of credits.
- Buy, sell, hold or otherwise deal in foreign exchange.
- Hold, acquire and sell negotiable instruments and securities by the government or private sectors.
- Keep in safes or otherwise, securities, jewels, precious metal and other valuables.
- Negotiate, underwrite or issue bond.
- Act as an agent for persons and, in this capacity, engage in the sell of money and shares.
- Control the end use of credits, loans and other facilities that it provides to its customers.
- Acquire, possess, own, mortgage, sell, exchange and dispose of property for the purpose of attaining its objectives and the proper functioning of its operations.
- Perform other banking activities customarily carried but by commercial bank.

Figure 3.12 Head Office, Commercial Bank of Ethiopia

After the fall of the Military Government in 1991, the Transitional Government of Ethiopia issued market economic policy. Proclamation number 84/94 allowed the Ethiopian private sector to establish privately owned banks. Awash International Bank was established as the first private bank. Dashen Bank, Abysinia, Wegagen Bank and other private banks were established since then.

Activity: 4

1. **Write a short note on the development of banking in Ethiopia**
2. **Discus the role of National Bank of Ethiopia.**

3.5 Risk and Insurace

3.5.1 Risk

A risk may be defined as the possibility of an unfortunate occurrence or exposure to losses. A human being has always encountered risks, some inconsequential and some with serious impact. Risks with insignificant consequences usually do not lead us to trouble. However, it is desirable to escape from serious risks as much as possible. But if the risk cannot be avoided the next best thing is to try to minimize the consequences.

Many people accept the risk of losing an umbrella without much concern. But if an individual's home is destroyed by fire, the risk entails consequences that cannot be ignored. The owner may avail himself/herself of some means to reduce his/her financial loss.

Risks are encountered in business activities. For example, the proprietor of a store may be sued for having defective stairs that resulted injury to a customer, and may be fined 10,000 birr. We also know that businesspersons have their store fixtures damaged by fire, may suffer depreciation in the value of goods, incur loss, or have their cash stolen. The occurrence of such uncertainties that may cause damages leads to the desire for more security. The desire for security is the basis of insurance.

There are two types of risks:

a) Speculative risk
b) Pure risk

a) Speculative risk: is one whose consequences may be either favorable or unfavorable. Thus, the purchaser of wheat may have to sell the wheat at a loss. On the other hand, if the price rises he/she will have a profit. The proprietor of a business may lose his/her investment due to competition, a change in the import tariff, new invention, governmental policies and the like, but he/she may also make a small fortune in favorable conditions. The buyer of a house may have to sell it later at a loss, but he/she may make money on the transaction.

Most risks of this nature are unfortunate only to some individuals and not necessarily to society as a whole. Thus the loss for one person from the sale of a house is the gain of another; the decline in the wheat price enriches some persons at the expense of others; the decline of one business establishment may mean larger profits to others. The other feature of these risks is that they are often non measurable, that is, we lack the information about their occurrence that would permit reliable estimation of their probable frequency and severity.

Protection against these risks is available or utilized only to a limited extent and in isolated instances because 1) elimination of unfavorable consequences may cost too much relative to the potential gain or even eliminate the possibility of gain. 2) many persons prefer to accept such risks 3) there is little information upon which to base an insurance payment and 4) Insurance against these contingencies involves too much moral risk.

b) Pure risks: as distinguished from speculative risks always entail serious and harmful consequences. Some of the examples of pure risks are fire that destroys property, the breakage of a window, the loss of employment, etc. All of these consequences are unfortunate, not only for the individual sufferer but also for society as a whole. There is no possibility of gain. Consequently it is extremely important that the person seeks ways to compensate these risks.

Accidental destruction of business property is a good example of an insurable risk. It is a pure risk because it is not a basic risk of business investment. The value of the property can be determined accurately. An individual business is not likely to be destroyed by fire if precautions are observed. There is, however, enough risk to all businesses that large number of them are willing to pay premiums for protection.

Though some of these risks are non-measurable, many of them are measurable. For example, the consequences of a premature death can be predicted; total loss that will be incurred through fire can be approximated in advance. As a result, many of these risks are insurable with life insurance, property insurance, etc. Insurance, however, is not the only method of meeting risk.

? Describe the difference between speculative risk and pure risk with examples that really occurred in your locality.

3.5.1.1 Risk Management

Business management can respond to risk in a number of ways. They can respond in the following principal ways:

A) Sound management
B) Risk reduction
C) Self-insurance
D) Purchased insurance

a) Sound Management: Sound management is clearly the best way to reduce speculative risk. Careful control of financing, product development and production, marketing and distribution, and other management concerns help to insure that the result of speculative risk will be profits rather than loss and failure. Good credit management will reduce losses from bad debts and delayed payments. Good human relations management can reduce losses from strikes or other labor problems. Good general management policies also reduce pure risk. Well-trained personnel with good morale, using modern equipment with proper maintenance eliminate or minimize many accidents.

b) Risk reduction: Good managers take steps to reduce insurable risks. Many company specifically train employees in safe working procedures. Buildings may be built with fireproof materials. Plant and office security systems reduce theft and danger to employees. Machine designs and building layouts can also be made safer.

c) Self-Insurance: One sound way to deal with insurable risk is to remain financially prepared to accept a loss without damaging a business's strength. Small losses must be accepted as daily occurrences. Some materials and inventory will be damaged or lost. Machinery will break down. Windows will be broken. For most companies, these small losses are normal business expenses. Some companies also establish reserve funds to be used if a major loss occurs.

This practice is called self-insurance. The advantage of self-insurance is that the money in the reserve can earn interest for the company. Self-insurance, however, is usually practical only for large companies and for a limited range of risks. It is very difficult to keep large reserve to cover all possible risks which will tie up so much money that harms normal business operations. Large companies with numerous stores or plants in different locations, however, may be able to use self-insurance against fire since it is unlikely that more than one facility will burn at a time.

? Discuss risk management by relating to business activities that you observe around your locality.

d) Purchased insurance: Nearly most companies rely on purchased insurance to protect them against pure risk. Despite good management, risk reduction efforts, and the ability to accept some losses, there will always be risks that threaten the company's strength Insurance is usually the answer.

Insurance as a risk management tool can be defined as follows.

Insurance can be defined from two points of view. First, insurance is the protections against financial loss provided by an insurer. Second, insurance is a device by means of which the risks of two or more persons or firms are combined through actual or promised contributions.

Insurance can be bought as protection against pure risk. Insurance companies make contracts with businesses agree to pay these businesses for losses resulting from pure risk. The insured business makes regular payments, called *premiums*, to the insurance company. When the insured business or individual enter into a written agreement with the insurance company, the agreement is called *a policy*. The person who buys insurance is called the *policyholder*. The insurance company can afford to pay for losses at any one time.

From the functional standpoint, insurance is a social device whereby many individuals may make small periodic contributions and those who suffer losses may be reimbursed. As such, it is a social device where by many share the losses of a few. *By the underwriting process, an insurance company contracts to reimburse an insured for certain described losses*. In its legal aspect insurance is a contract where the insurer agrees to reimburse any financial loss the insured may suffer within the scope of the contract, and the insured agreeing to pay a contribution. The insurer may be a corporation, an association, or an individual. The varying forms of organizations that assume risk may be conveniently referred to as the insurance carrier (insurer). The individual who is relieved of the risk is known as the insured.

? Describe the relations and difference between insurance premium and insurance policy.

3.5.1.2 Essential Requirements for Insurance

In order to make insurance contracts operate equitably and produce the desired benefits, and be practical from a business point of view, the following conditions are necessary.

1. The insured must be subject to a real risk. This risk may be loss of goods or benefits that he/she has already possessed or of prospective benefits or profits. It is important that the contract be based upon someone’s actual possibility of loss and not upon the mere desire of the insured to be against the happening of some event. It is preferable that *the risk be such that the insured cannot produce the event or increase the probability of its happening*. At least he/she should have no incentive for doing so.

2. The cost of insurance must not be prohibitive. In order for insurance to be of any great benefit to a large portion of the business community, the premium paid must be within the reach of nearly everyone. Otherwise the risks undertaken will be confined to a small and selected group of persons, which is insufficient in number and thus harming the insurer.
3. The extent of the potential loss from the risk must be measurable in some fairly accurate way. It is necessary that the extent of the hazard involved be capable of approximate mathematical calculation. An insurance company could not sell guarantees of future protection without some estimate of future losses. This is the basis to determine the amount to be insured.
4. The likelihood of any individual business suffering an immediate loss from a given risk must be slight. For example, a person caught by a deadly disease might be refrained to enter into a life insurance policy.
5. There must be very large number of companies subject to the risk. Many companies must contribute to the pool to provide enough money to pay for the losses.
6. One of the fundamental requirements among those enumerated above is that the insured person must possess some real interest in the subject matter insured a doctrine known as the necessity of an insurable interest.

? Form a group consisting of five to ten members and discuss the requirements of insurance by taking specific business enterprise.

3.5.1.3 Principle of Insurance

Insurance contracts are based on the following fundamental principles:

a) Good faith
b) Insurable Interest
c) Indemnity
d) Subrogation

a) Good faith: The parties that are concerned in insurance contract are obliged to have utmost good faith. In this way, insurance contracts are different from the ordinary business contracts, which are based on the rule of "let the buyer take care." For example, in an ordinary contract of sale of goods, the buyer is expected to take all care necessary to ensure the quality of the goods he/she wants to buy. If the goods turn out to be unsatisfactory, the buyer will have no solution against the seller and will have to bear the consequence. But in insurance contract of any kind, each of the parties is under an obligation to open or tell all the facts as they may have some influence on the decision of the other party to enter into such a contract. The responsibility to tell all facts mainly rests with the insured, which has all-important information about the subject matter of insurance.

b) Insurable Interests: According to this principle, no person can enter into a legal contract of insurance unless he/she has an insurable interest in the object or life insured. Insurable interest means an interest in an object or life, which brings the insured financial benefit in the case of its safety, and financial loss in the case of its loss or damage.

c) Indemnity: The main purpose of insurance is to transfer the loss suffered by a person to the insurance company. The insurance company can easily spread the loss over a large number of policyholders. It is, therefore, necessary that the person that lost his/her property cannot be allowed to get more than the amount that lost by certain incident. For practical reasons, the insured cannot be permitted to make a profit out of his/her loss.

d) Subrogation: According to this principle, the insurer becomes entitled to all the rights of the property of the insured once claim of the insured has been fully and finally paid. In other words, after the insurance company pays the claims of the insured against his/her loss, the scrap or whatever is left of the damaged or destroyed property will automatically belong to the insurance company.

? **Discuss each of the insurance principles identified above.**

3.6 Classifications of Insurance

The various types of insurance coverage have been grouped into several classes. These classifications have come about by practice within insurance company offices, and by the influence of legislation controlling the financial aspects of transaction.

Providers of insurance have originated hundreds of different kinds of policies covering insurable risks in various combinations. The following can be taken as the classifications of insurance.

1) Fire Insurance
2) Marine Insurance
3) Motor Insurance
4) Theft Insurance
5) All risk insurance
6) Accident Insurance
7) Employer's liability Insurance (work men's compensation)
8) Life Insurance

3.6.1 Fire Insurance

As the name suggests, fire insurance covers damage to buildings and contents caused by fire, lightening and explosion of gas or boilers used for domestic purposes such as heating and cooking. These domestic uses can of course occur in factories and canteens. The standard fire policy covers the following:

i) Fire (including fire resulting from explosion)
ii) Lightening
iii) Explosion of boilers used for domestic purposes only
iv) Explosion of gas used for domestic purposes only or for lighting in a building or forming part of any gas works.

3.6.2 Marine Insurance

Originated for protection against the risk of shipping goods at sea, it has now been extended to cover other kinds of shipping. The two distinct marine insurances are:

1) Ocean Marine Insurance
2) Inland Marine Insurance

3.6.2.1 Ocean Marine Insurance

Marine insurance protects goods and ships while they are at sea and temporarily while they are in port. Ocean marine insurance provides cover for the whole machinery, materials and outfit stores and provisions for the officers and the crew. Although specific variations are possible, policies usually cover sinking, fire and water damage and vandalism as well as other kinds of damage.

3.6.2.2 Inland Marine Insurance

Inland marine insurance is related to an insurance coverage of goods in transit from one place to another by air, rail, road, or registered post. The inland marine insurance covers the risks of shipping goods in inland waterways. Such policies are issued to cover cargo transported over inland water and cargo in transit by railroad or registered post. Goods in transit are normally protected against loss or damage resulting from accidents such as train collisions, derailment and road accidents. Coverage also usually includes damage from fire, wind, earthquakes and other natural forces. Damage caused by people, such as theft or vandalism, may or may not be covered in a specific policy. Cargo insurance is related to export or import shipments.

? **Describe the difference between fire insurance and marine insurance.**

3.6.3 Motor Insurance

Policies are available for private cars, motorcycles, goods-carrying vehicles, public services such as buses and taxis, agricultural vehicles and special types which include road rollers, excavators and levelers. Motor Insurance has five major classes namely, Private Car Insurance, Commercial Vehicles, Motor Cycles, Motor Trade and special types.

Private Car Insurance is related to private cars that are used for social and domestic purposes. Comprehensive policies issued to individuals also include personal accident benefits for insured and the spouse, medical expenses and loss or damage of rugs, clothing and personal effects.

Commercial Vehicles Insurance policy covers all vehicles used for commercial purposes such as lorries, buses, vehicles used for taxi purposes and etc. Such vehicles are not insured under private car policies but under special contracts known as commercial vehicle policies.

Motor Cycles Insurance policy depends upon the machine whether it is a moped or a high-powered motorcycle, and it also depends on the age and experience of the cyclist. The cover is comparatively inexpensive relative to motorcar insurance.

Motor Trade Insurance policy is offered to garage owners and other people engaged in the motor trade to ensure that their liability is covered while using vehicles on the road. Damage to vehicles in garages and showrooms can also be included under such policies.

Special Types This classification of insurance refers to “land vehicles other than railway rolling stock” and many such vehicles fall under a category known to insurers as “special types”. These will include forklift tracks, mobile cranes, bulldozers and excavators. Such vehicles may be on roads as well as building sites and other private grounds. Where special type vehicles are not used on roads, they are transported from site to site and it is more appropriate to insure the liability policy, as the vehicle is really being used as a tool or trade rather than a motor vehicle.

? **Discuss the different types of policies available to protect motor vehicles.**

3.6.4 Theft Insurance

This policy is designed to cover any act of stealing of the contents of offices, shops, warehouses and other business premises against loss or damage by theft following visible and forcible entry into or exit from the premises. The theft must force the normal security fittings of the premises to gain entry or exit.

3.6.5 All Risks Insurance

The all risks policy covers the property specified against any loss or damage (including fire and theft) unless and otherwise specifically excluded or mentioned. Special policies of these types are available for:

- Office equipment
- Computers
- Special machinery
- Construction projects
- Money
- Goods-in-transit
- Holiday baggage
- Personal effects

3.6.6 Accident Insurance

Accident insurance policies usually provide one or more of the types of coverage: a) it may pay some or all of the expenses of hospitalization, surgery, and other medical care resulting from accidents or illness b) it may pay the insured some or all of the income lost when illness or injury prevents working or c) it may make lump sum payments for loss of sight or limbs or for death resulting from an accident.

? Discuss the different types of insurance policies described above.

3.6.7 Employer's Liability Insurance (Workmen's Compensation Insurance)

This form of insurance is designed to protect an employer against legal liability that he/she may incur as a result of death or bodily injury sustained by his/her employer's liability policy that will provide him/her exactly the same amount he/she has had to pay out. In addition, the policy also pays certain expenses such as lawyer's fees and medical expenses paid for the treatment of the injured employee. Worker's compensation insurance usually pays for medical expenses and for a portion of worker's salaries while they are unable to work. Worker's compensation also usually makes a payment to worker's family if death results from a job-related accident. However, willful or injury caused by intoxication are not covered.

3.6.8 Life Insurance

In return for premiums, life insurance pays a sum to survivors if the insured dies while the policy is in effect. Many policies include provision for the accumulation of savings and other special features. Its basic purpose, however, is to repay survivors for some of the financial losses that result when a person dies. Medical and funeral expenses must be paid. Outstanding debts may be a burden. Loss of income formerly provided by the insured may greatly lower the standard of living of survivors.

A premium of life insurance differs in an important way from other kinds of insurance. Premiums for fire insurance, for instance, are based on an estimation of the likelihood that a fire will occur. In contrast, death is certain. The only unknown factors are the time and the cause. Life insurance policies can be categorized as a) whole-life b) endowment and c) term life insurance.

Whole-life Insurance may be considered the standard life insurance policy. It is bought for its protective features. The insured makes equal payments periodically from the purchase date until his/her death. When the insured dies, the face value of the policy is paid to his or her survivors or to other specified people or organizations. This type of insurance automatically includes a saving plan.

Endowment Life Insurance policies emphasizes the savings possibilities more than does whole-life. Higher premiums are charged so that the cash surrender value increases rapidly. Premiums are set so that in a specified number of years the cash value will have added up a saving fund equal to the face value of the policy. At this time, the insured may collect the face value of the policy or elect to receive annual payments. Endowment life is the only type of life insurance that allows the insured rather than the beneficiary to collect the face value of the policy.

Term Life Insurance provides payment if the insured dies within a certain number of years stated in the policy. A 10-year term policy, for example, requires the regular payment of premiums for ten years and pays the face value of the policy if the insured dies within that period. If the insured does not die during the specified term, all premiums remain the property of the insurer.

Each kind of life insurance policy has advantages and disadvantages and is best suited to particular situations. Term policies provide inexpensive protection for temporary periods. Term policies are difficult and expensive for older people to buy. Whole life insurance is a compromise between term and endowment policies. It provides good protection at a reasonable cost. Whole life insurance is more expensive than term life insurance and does not have the extensive saving capabilities that endowment policies have. Endowment policies stress saving more than protection. The premiums are the highest of the three types. The savings features of endowment policies can only be judged in comparison with other types of investment.

? Discuss the different types of life insurance policies and their advantages in relation to your community.

3.7 The Practice of Insurace In Ethiopia

Europeans have introduced modern forms of insurance services to Ethiopia. Indigenous self-help associations such as EKUB and IDIR had existed earlier and have been used for centuries. These traditional forms of social security due to their operational simplicity and their voluntary nature are still active, widespread and strong in various parts of urban and rural Ethiopia providing their members with financial and material assistance.

The practice of insurance services in its modern sense is a recent phenomenon, which is said only to have been started in the early 1920's. This was when the then Bank of Abyssinia began to underwrite fire and marine insurance as an agency to a foreign company. In Ethiopia, an Austrian named Muzinger, as an agent of a foreign Fire Insurance Company, established the first service rendering insurance company in 1923. For the first time this company gave compensation for a customer enterprise that has lost a warehouse as a result of fire damage in 1929. During the Italian invasion (1936-1941) no other insurance companies were allowed to operate except the Italian Insurance Companies. After the end of World War II different foreign insurance companies began to operate once again. Later on a number of British Insurance Agents were widely operating in the country.

Despite all the achievements in the expansion of insurance services in the country, all of them had their head offices abroad. An insurance company with its head office in Addis Ababa was established for the first time in 1951. This company of Ethiopia gradually continued to expand the insurance business from the capital city to the major towns of the country. Before the DERG came to power, there were 13 insurance companies operating in the country. On January 1975, DERG nationalized all banks and thirteen insurance companies. This paved the way to the operation of the insurance services in a centralized and consolidated manner and thereby led to the establishment of Ethiopian Insurance Corporation in January 1976 with the following major objectives.

a) To engage in all classes of insurance business in Ethiopia
b) To ensure that the insurance services reach the broad masses of the people
c) To promote efficient utilization of both material and finance insurance resources.

After the fall of the Military Government in 1991, the Transitional Government of Ethiopia issued an economic policy which laid the foundation for a transition from centrally planned economic system to market economy, a system in which the critical role of the private sector in development is fully recognized. In the insurance industry, a number of Ethiopian Entrepreneurs grabbed the opportunity and established insurance companies. Many private insurance companies were established since then.

3.7.1 Mahber, Eder and Ekub

Besides banks and other financial institutions in Ethiopia, there are various traditional associations that provide financial service. These associations encourage the residents of specific or given community or kebeles to save a certain amount of their earnings or income in order to meet different social needs for the purposes of self-help and mutual assistance. Such associations may be formed by any group of people who wish to get together in order to help themselves and to offer services to each other. Mahber and Idir are associations in society for mutual aid and burial. Ekub is thrifty or rotating credit society. These three associations are known and have been in use for many years in Ethiopia.

Activity: 5

Identify an insurance company in your locality and do the following.

1. **Report when it was established and what type of insurance coverage it provides and the number of insurance holders.**
2. **Identify its rates for insurance premiums and its insurance policy on various coverage and present to the class.**
3. **List the steps involved in buying insurance policy.**

3.8 Investment Policies In Ethiopia

Investment means expenditure of capital by an investor to establish a new enterprise or to upgrade that exists for profit. Currently, in an effort to contribute their share to the economic development of Ethiopia, many investors have established new enterprises or expanding existing ones with huge amount of capital.

There are two types of investors, namely: Domestic Investor and Foreign Investor.

3.8.1 Domestic Investor

According to the Ethiopian Investment Policy, a " Domestic Investor" includes

- An Ethiopian
- A foreign national permanently residing in Ethiopia
- Government and public enterprises
- Cooperative societies established in accordance with the relevant law
- A foreign national who is Ethiopian by birth and wishing to be considered as a domestic investor.

3.8.2 Foreign Investor

According to the Ethiopian Investment Policy, a "Foreign Investor" means:

- A foreign national who has invested foreign capital in Ethiopia.
- An existing enterprise owned by foreign investors.
- Ethiopian, permanently residing abroad and preferring to be treated as a foreign investor.
- A joint venture established between a foreign investor and a domestic investor.

3.8.3 Areas of Investment

The investor could choose the most feasible project from among the potential areas of investment. It is therefore important to identify in advance the areas of investment that are reserved for domestic investors by the investment proclamation.

3.8.3.1 Areas Reserved for the Government

The following investment areas are exclusively reserved for the government:

1. generation of hydroelectric power, generation and supply of electricity above an installed capacity of 25 Megawatts as well as transmission and supply of electrical energy through the integrated National Grid System.
2. Air transport services using aircraft with a seating capacity of more than 20 passengers or with a cargo capacity of more than 2,700 kg.
3. Rail transport service.
4. Postal services with the exception of courier services.

3.8.3.2 Areas Reserved for Join Venture with the Government

Investors shall be allowed to invest in defense industries and telecommunication services only in partnership with the government.

3.8.3.3 Areas Reserved for Ethiopian Nationals

The following investment areas are exclusively reserved for Ethiopian Nationals. Foreign nationals are not allowed to invest in these areas.

1. Banking and Insurance business.
2. Excluding generation of electricity from hydropower, generation and supply of electricity of up to 25 Megawatts.
3. Air transport services using air craft with a seating capacity of up to 20 passengers or with a cargo capacity of up to 2,700 kg.
4. Forwarding and shipping agency service.

? Discuss with your classmates why foreign nationals are not allowed to invest in banking service, air transport, etc in Ethiopia.

Nevertheless with the exception of areas exclusively reserved for the government or areas reserved for joint venture with the government, other investment areas are open for Ethiopian Nationals.

3.8.3.4 Areas of Investment Reserved for Domestic Investors

In accordance with the Regulation No. 35/1998, the following areas of investment are exclusively reserved for domestic investors:

1. Radio and television broadcasting services
2. Retail trade and brokerage
3. Wholesale trade (excluding supply or petroleum and its by products as well as wholesale by foreign investors of their products locally produced)
4. Import trade
5. Export trade or raw coffee, oil seeds, pulses, hides and skins and live sheep goats and cattle not raised or fattened on own farm
6. Construction companies excluding grade 1 contractors
7. Tanning of hides and skins up to crust level
8. Hotels other than star-designated, motels, pensions, tea rooms, coffee shops, bars, night clubs and restaurants excluding international and specialized restaurants
9. Tour operations, travel agency, commission agency and ticket offices.
10. Car, air and taxi-cabs transport
11. Commercial road transport and inland-water transport services
12. Bakery products and pastries exclusively for the domestic market

13. Grinding mills
14. Barber shops, beauty salons, gold smith and tailoring excluding garment factories
15. Building maintenance services, repair and maintenance of vehicles
16. Saw mills and manufacture of wood products exclusively for the domestic market
17. Customs clearance services
18. Museums, theaters and cinema hall operations
19. Printing industry
20. Artisans mining

Domestic investors could also invest, without any capital restrictions, in all the other areas that are not reserved for the Government.

3.8.3.5 Areas of Investment open for Foreign Investors

With the exception of areas reserved for the government, for Ethiopian Nationals, or for domestic investors as well as areas reserved for joint venture with the government, all other areas are open for foreign investors. Where the government permits under special provisions, forwarding and shipping agency services shall also be open for foreign investors.

In a joint venture between foreign and domestic investors, the equity share of the domestic investor in the registered investment capital shall not be less than 27%.

Activity: 6

Form a group and discuss on each of the investment areas reserved for domestic investors.

1. **Differentiate between domestic and foreign investors.**
2. **State investment opportunities in your locality.**
3. **List some of the investment areas allowed for foreign investors.**
4. **Discuss the advantages of attracting foreign investment in Ethiopia.**
5. **List profit oriented organizations established following the investment policy in your locality.**

Summary

1. Money is anything that people will accept in exchange for their goods and services in the belief that they may in turn exchange it for other goods and services.
2. Money serves as a) standard of value b) medium of exchange c) store of value d) standard of deferred payments.
3. The possible sources of capital for investment are a) owner's capital or equity financing 2) loan or debt financing.
4. Equity financing involves the use of funds contributed by or from owners to finance operations while debt financing is the use of borrowed money for the same purpose.
5. Equity financing can be done through the sale of stocks or shares (units of ownership) and debt financing is done through short-term bank loans, mortgage loans and bonds.
6. A bond is a written pledge to lenders stating the borrower's intention to repay a loan. Stockholders are the owner of the corporation assets unlike the bondholders who lent money for corporations.
7. A bank is a business enterprise that deals with money and credit. Almost all banks offer three important services: a) accept and safeguard money deposits b) transfer money payment made by cheque c) make loans to individuals, businesses and governments.
8. The National Bank is the government bank and at the same time the bankers' bank that supervises financial activities of commercial banks. Commercial banks provide saving and credit services to their clients.
9. The primary factors of credit granting are based on five essential elements called the 5C's. They are: Character, Capacity, Capital, Collateral and Confidence.
10. Modern banking in Ethiopia began in 1905, when the Bank of Abyssinia was first established in Addis Ababa.
11. A risk is defined as the possibility of an unfortunate occurrence. There are two types of risks: speculative risks and pure risks.
12. Business managers can respond to risk in a number of ways: Some of the ways are:
    1. sound management
    2. risk reduction
    3. self-insurance
    4. purchased insurance
13. Insurance can be defined as the protection against financial loss provided by an insurer and it is a device by means of which the risks of two or more persons or firms are covered through actual or promised contributions.
14. Investment refers to the expenditure of capital by an investor to establish for profit a new enterprise or to upgrade on that exists. There are two types investors in Ethiopia: Domestic Investors and Foreign Investors.

Review questions

Part I. Choose the best answer from the given alternatives.

1. Without money the price of every good has to be expressed in terms of exchange ratios with all other goods or services. This statement refers:
   a) Money serves as medium of exchange.
   b) Money serves as a store of values.
   c) Money serves as standard of values.
   d) Money serves as a means of deferred payments.
2. Identify a false statement
   a) The material used as money must be easily divided.
   b) The material used as money should be easily spoiled.
   c) Money must be easy to carry.
   d) The paper out of which the paper notes are printed should be of the same quality.
3. When funds are raised through the contribution of the owner, it is called ___________
   a) Debit financing
   b) Equity financing
   c) Capital raising
   d) Bank deposit
4. What is the type of loan facility that provides the uses to withdraw more than the amount kept in checking account?
   a) Short-term loans
   b) Long-term loans
   c) Over-drafts
   d) Middle-term loans
5. What is the written pledge to lenders stating the borrower's intention to repay a loan?
   a) Principal
   b) Cheque
   c) Bond
   d) Trustee
6. Which of the following term applies to groups of traits that have social significance and moral quality?
   a) Capacity
   b) Confidence
   c) Capital
   d) Character
7. What is the possibility of an unfortunate occurrence of exposure to losses?
   a) Insurance
   b) Risk
   c) Loan
   d) Fund
8. Which of the following term signifies transferring the loss suffered by a person to the insurance company?
   a) Subrogation
   b) Interests
   c) Indemnity
   d) Assurance

Part II. Define the following terms.

1. **Money**
2. **Bonds**
3. **Stocks**
4. **Collateral**
5. **Risk**

Part III. Answer the following questions with examples from your locality.

1. **Describe money in terms of its functions and characteristics.**
2. **Discuss the importance of the banking system in economic development.**
3. **List and explain the different types of life insurance policies.**
4. **What are the possible means that you suggest to attract foreign investors?**

Unit 4

PRODUCTION

Unit Outcomes:

After studying this unit, you will be able to:

- define production.
- explain the terms input, process and output.
- identify the four kinds of factors of production.
- identify the role of entrepreneurship.
- explain variable and fixed costs of production.
- describe the use of considering different location of facilities.

Introduction

Production is an activity of people towards the creation of things, which they need or want. In more elaborative sense production refers to the economic process of converting inputs into outputs. Production uses resources to create a good or service. To produce a given product inputs are required. Inputs are the materials and services used in the production process. At the other end of the process we get outputs. The goods or services that a firm produces for sale are called outputs. The inputs required to produce manufactured products include labor, capital and intermediate inputs such as other manufactured products. In other words inputs to manufactured products include factors of production and purchased intermediate inputs that were originally produced with factors of production by other firms. The factors of production are natural and manmade resources such as land, labour, capital and entrepreneurship. In this unit, the concept of production, production function, factors of production, costs of production and various factors that influence the choice of location of business will be discussed.

Contents of the unit

In order to achieve the above objectives: you will learn the following topics:

- definition of production
- production function
- factors of production
- costs of production
- Location of facilities for production process

4.1 Definition of Production

? Have you visited any manufacturing plant?

Definition: Production is the process of converting inputs into goods and services, which people need or want.

Production is the process of blending and utilizing labor, machines and other inputs together to make goods and services available. The word production often is used in the sense of making things. In fact, for too many persons production is manufacturing. However, manufacturing is simply a special form of production by which raw and semi- finished materials are processed and converted into finished products needed by consumers. In a broader and more basic sense, production is the transformation of inputs (human and physical resources) into outputs desired by consumers. These inputs may be either goods or services. So, although a large restaurant is not considered as a manufacturing unit, it should be noted that it is engaged in production. In fact, there are many service companies engaged in production. Examples of service companies that are engaged in production are printing, cleaning and laundering, health care organizations. The production of services is often called **operations management.**

? Identify the production activities that you are observing in your locality.

Most things that people need or want are not at all available in nature or they are scarce. One does not find pairs of shoes, suits of clothes, loaves of bread, or radios growing in the woods. People do not go to the forest and collect the products mentioned. If people want these things, they must produce them. If needs or wants are to be satisfied, there must be production. Any activity, which helps to satisfy needs and wants, is defined as production. Production therefore, consists of those activities that provide goods and services, that satisfy needs or wants of individuals and for which they are prepared to pay money.

When we say business organization produces pens or cameras, we are not implying that it brought a new material into being. For example the things from which a camera was made, existed before and will exist long after the camera is worn out. But the camera did not exist before. In this sense we can safely say that the camera was produced. Someone took existing materials (raw materials) and changed them to more useful goods than they had been before. Wood, leather, glass and metal are shaped and combined in such a way that they could satisfy needs or wants that could not have been satisfied by the raw materials taken separately.

The following example makes clear the explanation above. W/ro Konjit Degu, a house wife makes a piece of cake. When she makes the cake, she combines 1 ½ cups of water, 1 cup of raisins, 1 cup of sugar, ½ cup of shortening, ½ teaspoon of cloves, ½ teaspoon of cinnamon, and two bars of chocolate; boils the mixture for 5 minutes; cools and adds 2 cups of flour, 1 teaspoon of baking soda, and ¼ teaspoon of salt. She then bakes the mixture for an hour.

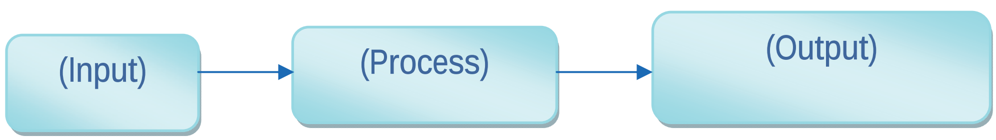

Figure 4-1 Production process

When she is through, she has produced cakes, and everyone who consumes it will agree that it satisfies needs or wants better than the ten ingredients taken separately. This is to say that the utility of the whole is not equal to the sum of the utilities of the separate parts. By combining the ingredients in the proper way there has been an actual creation of utility. Therefore, when we refer to production we mean creation of utility. **Utility** is the satisfaction that consumers receive from items they acquire, activities they engage in or services they use.

The most obvious way in which people add utility to material things is by changing their form. Producers change the forms of things that existed in nature, and put them into a form better able to satisfy wants in a more useful form. Such activities add **FORM UTILITY**.

After milk has been pasteurized and bottled or packed; it has been given the usual kind of form utility, it is still not usually ready for satisfying needs or wants. It must still be taken to a place where the consumer will get it and buy it. If the same milk can be shipped to big cities where the supply of milk is small in proportion to the population, it will be more useful. In big cities the milk can and will satisfy more wants. Thus we have created utilities in the milk, entirely different from any change in form, merely by taking it from one place to another. We would say that we have created **PLACE UTILITY**. All transportation agencies-railroads, airlines, motor trucks, etc are engaged primarily in adding place utility to goods. Transportation agencies carry the goods from where they are less useful to where they are more useful.

Just as things may be more useful in one place than in another, they may also be more useful at one time than at another. For example Teff stored from a year of heavy crop to a year of crop failure is a case in which things have gained more utility or value without change of form or place. Putting things from time of plenty to time of shortage adds **TIME UTILITY**. Advertising and promotion increases the value of goods and services by increasing public demand for them. Since advertising and promotion stimulate the feeling or awareness of desire to possess and use, they are creating **UTILITY OF POSSESSION**.

Activity: 1

1. **What is production?**
2. **Discuss how people add utility to a given material.**
3. **Define the following concepts. Support your discussion with examples drawn from your own observation of business practices.**
   - **Utility of form**
   - **Place utility**
   - **Time utility**
   - **Utility of possession**

4.2. Production Function

To produce a given product, we need inputs. Inputs are the materials and services used in production process. Consider for example, a bakery. Inputs for a bakery include raw materials such as flour used to make bread, the land on which the bakery is constructed, the building that houses the bakery, the machines and equipment used to bake bread, the display cases to sell it, and the labour used including bakers, sales persons, and janitors.

At the other ends of the process are outputs (i.e.) the goods or services that the firm produces for sale. A loaf of bread can be an example of an output from bakery. Outputs can be also animal products from farm, leather from a tannery, manufactured shoes from a shoe factory, teff or wheat from a farm, education from a school or medical services from a hospital.

Some of these outputs, however, are intermediate inputs in another production process. For example, farm animal products (hide and skins) are used by a tanner to make leather. The leather is then used to make shoes, which in turn becomes the inputs required by the shoemaker. In this way, outputs become intermediate products in a production chain that may involve several businesses. The firm at the end of the process is then using intermediate inputs that can be traced back to their original sources, although this tracing sometimes requires several steps. These original sources are called **production function**.

Definition: The relationship between inputs and outputs in the production process is called PRODUCTION FUNCTION.

In large firms, the production function is a complex relationship among many combined inputs and outputs. As a production function is the relationship between inputs and outputs in the production process, it describes the maximum level of output associated with every possible combination of inputs in the production process, for a given technology. **Technology** is defined as all the tools and methods available for production.

Production function is based on a given level of technology, by which we mean the technical sophistication of machinery and the production process. As technology changes, the production function also changes to give a new relationship between inputs and outputs. A technological improvement means that output increases for the level of inputs.

A technological improvement is a change in the technical sophistication of production process that results in greater output for the same level of inputs.

As stated above a production function represents the relationship between inputs and outputs for a given level of technology. But technology does change. Historical observation proves that today's goods and services are far different from the goods and services produced century ago. Today we see digital watches, synthetic fibers, electronic computers, airplanes, electric lights, automobiles, and similar products that were unavailable a century ago. Indeed, it would be hard to find a product or production process that has not changed as technology changed. Invention of new products, improvements of old products, or changes in the processes of producing goods and services are what we mean by technological improvements.

Technological improvements occur when new or improved engineering and technical knowledge allows more output to be produced from the same inputs, or when the same output can be produced with fewer inputs.

The following are examples of technological improvements:

- introduction of new hybrid seeds (*mirt zer*) increased productivity of corn, wheat and barley farming. The hybrid seeds have been obtained as a result of technological improvements.
- wide-body seats in passenger planes increased the number of passenger-miles per unit of input. If you extend this example to Ethiopian Airlines, Boeing 767 passenger planes have more seats than Boeing 707 passenger planes. This is true because of technological improvement too.

Activity: 2

1. **What are inputs? List down examples of inputs.**
2. **What are out puts? Provide examples.**
3. **List the three categories of factors of production.**
4. **What is production function?**
5. **What is meant by technological improvement? Give some local examples.**

4.3 Factors of Production

? Can you identify factors of production before reading the next section?

Production cannot take place unless the necessary resources are available. These resources may come originally from nature or may be manufactured products. The manufactured resources that are used as inputs to the production process are called intermediate inputs. Intermediate inputs sometimes back in the chain of proceeding processes came from natural resources. There could be no production of goods of any kind without natural resources. They are basic to production. These natural resources such as land are called the first factors of production or agents of production. By this we mean that production cannot be carried out without the use of natural resources.

Even if natural resources are basic to production, they are not ordinarily sufficient. As we pointed out earlier in this unit most things that people want do not exist at all in nature or at least they are not in sufficient quantities to satisfy their needs. Therefore, if people are to get what they want, they have to work. We must have the input of human effort; otherwise we get no cloth, no pens, no radios, no clocks, etc. So labour could be recognized as a second factor of production.

In some cases, perhaps, products are produced by natural resources and labour alone; by human effort expended on natural resources without the help of any other factor. But usually people find it advantageous to use tools, machinery, and equipment of various sorts to facilitate the production process. Such tools and equipment increases the output tremendously. When the farmers use tractors and moving machines their output by far increases as compared to when they are using bare hands. On the other hand assume that farmer worked unassisted (merely land and labour) without his/her tractor or moving machine and even without rake, hoe, or spade-just himself/herself with his/her bare hands and his elbow grease. Contrast the products of these two farming situations. The tools and equipment with which people work are called capital, and we would list it as a third factor of production.

The factors of production are often divided into four categories:

a) Natural Resources

b) Labour

c) Capital

d) Entrepreneurship

Definition: ***Factors of production are the inputs of natural resources, LAND, LABOUR, CAPITAL, and ENTERPRENEURSHIP that a firm uses to*** **produce outputs.**

4.3.1 Natural Resources

Natural resources include land used as sites for production, natural resources that are used in crude form in production.

The first factor of production, natural resources include land used as sites for structures or farming, ports and other facilities as well as natural materials that are used in crude form in production. Example of land and other natural resources are farmland, industrial sites, deposits of minerals, navigable rivers, and sources of hydroelectric power, timber and the advantages of a regional climate. Natural resources refer to all natural resources that can be used as inputs to production, for example minerals, water, air, forests, oil, and even such intangibles as rainfall, temperature, and soil quality are possible inputs for given production process. The key distinction between natural resources and certain kinds of capital is that natural resources are not easily altered by labour or capital expenditure. For example pieces of land in Awash state farms that have been irrigated represent more than land. At present, in Ethiopia, the income payment for the factor of production land is called rent.

? Identify the natural resources that are available in your surroundings. Discuss how it will be used for production process.

4.3.2 Labour

Definition: Labour represents the services of human beings in the production of goods and services. It includes both physical and mental effort of human being.

Labour is the factor of production with which you are most familiar. As defined above, labour is the physical and intellectual exertion of human beings. The efforts of a factory worker, a university professor, and carpenter are all considered as labour.

The number of workers, their general education, training and skills and their motivation to work are prime determinants of a nation's productive capability. The service of factory workers, truck drivers, sales people, college professors, police officers and physicians all are part of a nation's labour resources.

It is clear that some labour is valued (or paid) more than others. Why? One reason is that labour, like medical doctors are more valuable. This occurs when individuals devote money and time in increasing their labour skills. Individuals invest in their labour skills by going to college or attending special training. We also refer this development of labour skills as investment in human capital. **Human capital** is the accumulation of labour enhancing activities including health care that increases labour's productivity. Wages and salaries are the resource payments that are made for the use of labour. Salary is a fixed periodical payment paid to a person for regular work or services, whereas a wage is usually paid by the day or week for work or services which are of a more irregular nature.

WAGES *and* ***SALARIES*** *are the return to the labour factor of production.*

4.3.3 Capital

Definition: Capital is the equipment, tools, structures, machinery, vehicles, materials and skills created to help produce goods and services.

Capital is the equipment, tools, structures, machinery, vehicles, materials and skills created to help produce goods and services. The third factor of production, capital is composed of all manmade aids to production such as machines, tools, factory buildings, warehouses, stock of inventories, and the like are considered as a factor of production, refers to physical things. Capital is a man-made resource. Any product of labour and natural resources that are reserved for use in the production process is capital. Capital, like machinery could be purchased or leased. Capital also include interest which is a reward for capital.

4.3.4 Entrepreneurship

Entrepreneurs are key factors of production because they combine the other factors of production by buying or renting these factors to produce a saleable product. Hence entrepreneurs are individuals and organizations that combine natural resources, labour and capital to produce goods and services.

Profit *is the return to the entrepreneurship factor of production. Profit is residual after all other factors have been paid.*

The starting up of small businesses and adding them to an economy plays an important role in creating jobs, and brings about remarkable productivity and economic efficiency. Entrepreneurs have invented new products, developed the organizations and means of production to bring them to the market. They have introduced new technology and in some cases have made the utilization of resources different from existing ones. They have introduced new and more productive uses of resources. Much creativity of entrepreneurs has changed our pattern of living, and many services have been introduced to change or create new service industries. This situation therefore, made entrepreneurship play a major role in an economic system.

Definition: Entrepreneurship is the process of bringing together creative and innovative ideas and actions with management skills necessary to assemble the appropriate people, money and operating resources to meet an identifiable need and create wealth. Entrepreneurship may also be defined as a purposeful activity resulting in starting, promoting and maintaining economic activities for the production and distribution of wealth. It is also defined to mean the willingness to exercise initiative and take considerable risk to operate one's own business.

4.3.4.1. Definition of an Entrepreneur

An entrepreneur has natural or acquired ability to develop products and processes and to organize production to make goods and services available. An entrepreneur is a person who uses personal initiative to organize a new business.

An entrepreneur is a person who develops a new product, a new market or a new means of production. The entrepreneur assumes responsibility and risk for a business operation with the expectation of making profit. He/she generally decides on the product, acquires the facilities and brings the labor force, capital and production materials either to come up with new product or new business.

Entrepreneurs put their ideas and money on the line by entering in some areas of business. In effect, they are working aggressively to earn a profit despite competition and other risks of operating a business.

Young persons who go into business for themselves as entrepreneurs find that there are many opportunities in their local communities. Even if there are difficulties associated with starting a new business, such as shortage of financial and non-financial resources, lack of some experience in the proposed line of business, many individuals start their own business. Entrepreneurs, who start their own businesses, are adventurers, risk-takers and profit-seekers. They gather capital, organize business and manage it.

An entrepreneur is a person who has the combined skill of strength in both creativity and management that are basic to the conception and launching of new business as well as to make it grow and succeed. The behavioral qualities of an entrepreneur can be identified as the five P's of entrepreneurship, which are:

1. **Purposeful:** sets goals and strives diligently to accomplish them.
2. **Persuasive:** Influences others, such as bankers, suppliers, and customers, to assist in reaching desired goals.
3. **Persistent:** Pursue goals continually and often against odds. Setbacks and disappointments do not halt the efforts toward goal attainment.
4. **Presumptuous:** Strikes out boldly and acts when others hesitate to do so. Is willing to take calculated risks and to accept innovative approaches.
5. **Perceptive:** Should be able to understand how each separate decision relates to accomplishing established goals.

From the behavioral qualities of an entrepreneur, we can conclude that an entrepreneur is a person who takes the risk necessary to organize and manage a business and receives the financial profits and non-monetary rewards. If entrepreneurs are successful, the return to entrepreneurship is high profit.

Can you name out some of the entrepreneurs that you know in your locality?

The Task of an Entrepreneur

What makes the entrepreneur different from other types of managers? To answer this question we have to see the seven tasks of an entrepreneur given below.

1. ***Owning a business.*** When the entrepreneur actually owns a business he/she plays two roles at the same time: that of an investor and that of a manager. He/she understands the operation of the business better than an employed manager. This will put the entrepreneur in better position to make better decisions than the employed manager.

2. ***Establishing organizations.*** The entrepreneur is a person who undertakes the task of bringing the different elements of an organization (Labour, capital, natural resources) and giving them a separate legal identity. However entrepreneurs also buy organizations that have been already established and then develop them, absorb them into existing organization. Entrepreneurs make major changes in the organizations they have bought. The changes they make differentiate them from managers who manage within existing organizational structures by making minor or incremental changes.

3. ***Bringing Innovation to Market.*** Innovation is the most important part of entrepreneurship. It is the process of wealth creation. Innovation in business means new product or service, but it can also include:
   a) A new way of delivering an existing product or service
   b) New methods of informing the consumers about a product and promoting it to them
   c) New ways of organizing a company
   d) New approaches to managing relationships with other organizations
   e) The entrepreneur's task goes beyond simply inventing something new. It also includes bringing that innovation to the market place and using it to deliver value to consumers

4. ***Identification of Market Opportunity.*** An opportunity is a gap in a market where the possibility exists all the time, but they do not present themselves. If these opportunities are to be used to the utmost, they must be actively sought out and identified. Having identified them, the entrepreneur must follow them with a suitable innovation. (The meaning of innovation is something newly introduced. For example methods of doing something newly introduced are called innovation)

5. ***Application of Abilities.*** Entrepreneurs have special ability in deciding how to use resources in situations where information is limited. It is their ability that makes entrepreneurs valuable investors

6. ***Giving Leadership.*** Entrepreneurs need the support of other people to be able to introduce the new products and services they have innovated and market them. These people must, however, be supported and directed by (the leaders) entrepreneurs. To do this the entrepreneurs must show good leadership.

7. ***The entrepreneur as a manager.*** Finally the entrepreneurs are managers. What makes the entrepreneurs different from an ordinary manager is in the way they manage and their effectiveness, not the particular tasks they perform.

4.3.4.2 Entrepreneurial Traits

? Can you identify some of the traits that differs an entrepreneur from others?

In small businesses, where there is no depth of management, the leader must be there. You may not be able to afford a support staff to cover all business functions, and therefore you will need to work long hours. We all know people who use part of their sick leave each year when they are not sick. Entrepreneurs are not found in this group. At the end of the eight-hour day, when everyone else leaves for home, the entrepreneur will often continue to work into the evening, developing new business ideas. The following are entrepreneurial traits.

a) Self-Control

Entrepreneurs do not function well in structured organizations and do not like someone having authority over them. Most believe they can do the job better than anyone else and will strive for maximum responsibility and accountability. They enjoy creating business strategies and thrive on the process of achieving their goals. Once they achieve a goal, they quickly replace it with a greater goal. They strive to exert whatever influence they can over future events.

In large, structured organizations, entrepreneurs are easy to recognize by the statements they make: "If they wanted that job done right, they should have given it to me." A dominant characteristic of entrepreneurs is their belief that they are smarter than their peers and superiors. They have a compelling need to do their own thing in their own way. They need the freedom to choose and to act according to their own perception of what actions will result in success.

b) Self-Confidence

Entrepreneurs are self-confident when they are in control of what they're doing and working alone. They tackle problems immediately with confidence and are persistent in their pursuit of their objectives. Most are at their best in the face of adversity, since they thrive on their own self-confidence.

c) Sense of Urgency

Entrepreneurs have a never-ending sense of urgency to develop their ideas. Inactivity makes them impatient, tense, and uneasy. They thrive on activity and are not likely to be found sitting on a bank fishing unless the fish are biting. When they are in the entrepreneurial mode, they are more likely to be found getting things done instead of fishing.

Entrepreneurs prefer individual sports, such as golf, skiing, or tennis, over team sports. They prefer games in which their own brawn and brain directly influence the outcome and pace of the game. They have drive and high energy levels, they are achievement-oriented, and they are tireless in the pursuit of their goals.

d) Comprehensive Awareness

Successful entrepreneurs can comprehend complex situations that may include planning, making strategic decisions, and working on multiple business ideas simultaneously. They are farsighted and aware of important details, and they will continuously review all possibilities to achieve their business objectives. At the same time, they devote their energy to completing the tasks immediately before them.

e) Realism

Entrepreneurs accept things as they are and deal with them accordingly. They may or may not be idealistic, but they are seldom unrealistic. They will change their direction when they see that change will improve their prospects for achieving their goals. They want to know the status of a given situation at all times. News interests them if it is timely, and factual, and provides them with information they need. They will verify any information they receive before they use it in making a decision. Entrepreneurs say what they mean and assume that everyone else does too. They tend to be too trusting and may not be sufficiently suspicious in their business dealings with other people.

f) Conceptual Ability

Entrepreneurs possess the ability to identify relationships quickly in the midst of complex situations. They identify problems and begin working on their solution faster than other people. They are not troubled by ambiguity and uncertainty because they are used to solving problems. Entrepreneurs are natural leaders and are usually the first to identify a problem to be overcome. 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 problem-solving approach.

g) Status Requirements

Entrepreneurs find satisfaction in symbols of success that are external to themselves. They like the business they have built to be praised, but they are often embarrassed by praise directed at them personally. Their egos do not prevent them from seeking facts, data, and guidance. When they need help, they will not hesitate to admit it especially in areas that are outside of their expertise. During tough business periods, entrepreneurs will concentrate their resources and energies on essential business operations. They want to be where the action is and will not stay in the office for extended periods of time.

Symbols of achievement such as position have little relevance to them. Successful entrepreneurs find their satisfaction of status needs in the performance of their business, not in the appearance they present to their peers and to the public. They will postpone acquiring status items like a luxury car until they are certain that their business is stable.

h) Interpersonal Relationships

Entrepreneurs are more concerned with people's accomplishments than with their feelings. They generally avoid becoming personally involved and will not hesitate to sever relationships that could hinder the progress of their business. 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.

Their lack of sensitivity to people's feelings can cause turmoil and turnover in their organization. Entrepreneurs are impatient and drive themselves and everyone around them. They don't have the tolerance or empathy necessary for team building unless it's their team, and they will delegate very few key decisions. As the business grows and assumes an organizational structure, entrepreneurs go through a classic management crisis. For many of them, their 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 were adequate during the start-up phases, will cause them problems as they try to adjust to the structured or corporate organization. Entrepreneurs with good interpersonal skills will be able to adjust and survive as their organization grows and becomes more structured. The rest won't make it.

i) *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 setbacks or failures. Entrepreneurs are uncomfortable when things are going well. They'll frequently find some new activity on which to vent their pent-up energy. They are not content to leave well enough alone. Entrepreneurs tend to handle people problems with action plans without empathy. Their moderate interpersonal skills are often inadequate to provide for stable relationships. However, the divorce rate among entrepreneurs is about average.

4.3.4.3 Motivation for Starting Business

? Do you have a desire to start a business? If your answer is yes what is your reason?

Ask any entrepreneur and they will openly tell you all the reasons **not** to start a business. All the frustrations, difficulties and painful times. But then they'll launch into all the reasons why you **absolutely must start a company, and do it right away**. Most entrepreneurs are like late night infomercial maniacs when it comes to promoting the startup life to others. Here's what they'll be pitching:

1. ***Passion.*** The passion you feel as an entrepreneur – for the startup life, for your company, for your vision – is all-encompassing. You're driven to succeed, to experience everything a startup has to offer, and to make things happen. Passion is a prerequisite to starting a business, and it's also a huge motivator, because through your startup you fuel your passion.
2. ***Creating Value.*** Entrepreneurs are creators. We need to produce "stuff" in order to succeed. And that "stuff" needs to create value. It's extremely motivating to know that something you've started has created value for others. And part of creating value is contributing to the entrepreneurial community on a whole. For me, this is a particularly motivating factor; I'm able to build a company, blog about it and communicate to others about my experiences.

3. ***Changing the World.*** Not every business has the potential to change the world, but many entrepreneurs take this mantra to heart. Lots of entrepreneurs believe their businesses will change the world. It's part of creating value. Starting a business and tossing yourself into it with unequivocal passion, gives you the chance.
4. ***Being in Control.*** Entrepreneurs are control freaks. We believe we can do things better than others, and off we go! Having that opportunity is on one hand motivating and on the other hand scary – you're in control, you're the boss, you better get out there and make things happen. Luckily, being in control feeds many of the other motivating factors, so it all comes together.
5. ***Money.*** There's no question that money is a motivating factor, although it belongs at the bottom of the list. The truth is that you can probably earn more money at a fairly high paying job, over enough years, than you can starting a business because of the likelihood of failure. But the only way to hit a financial home run is with a startup. You get to take your swing at the plate and aim for the fences.

4.3.4.4 Success Factors for Entrepreneurs

Running a one-person business is a creative, flexible and challenging way to become your own boss and chart your own future. It is about creating a life, as it is about making a living. It takes courage, determination and foresight to decide to become an entrepreneur. From the relatively safe corporate world, where paychecks arrive regularly, you will be venturing into the unchartered territories of business. Is there a way to determine whether you can be a successful entrepreneur, or you are better off to work for somebody else? There is no formula for success. However, most successful entrepreneurs share these ten characteristics. Check if you possess any one of them:

a. Think success. To attain the kind of success that you want, you need to dream big. Every success story starts with big dreams. You need to have big dreams for yourself - which you want to be somebody rich, famous or fulfilled. You need to have a clear vision of what you want to achieve. But it doesn't stop in dreaming alone. You should actively visualize success in your mind that you can almost feel it, touch it or it is within your reach. Play this image back at every opportunity. What does it feel to triple your current income? How will your life change? What will your business look like if you achieved the million-dollar mark?

Successful entrepreneurs possess an attitude of openness and faith that you can have what you want if you can simply envision it as the first step on the path of action to acquiring it. Management gurus have taught us the power of visualization - seeing yourself in your mind as having accomplished your dreams. If you want to be a successful writer, envision yourself signing books for a mass of people who have lined up to have your autograph. If you want to be rich, picture yourself in luxurious surroundings holding a fat bank account. And the process of envisioning success for you should be a constant activity! You need to think that you are successful (or will be one) every single waking hour. A personal development coach shared me her secret to help her continuously visualize her goals for the moment: when climbing stairs, recite your goal with every step you take. So if you want more money, say "I will have money" in every step of the stairs. This technique will reinforce your goal and keep it fresh in your consciousness.

b. ***Be passionate with what you do.*** You start a business to change any or all part of your life. To attain this change, you need to develop or uncover an intense, personal passion to change the way things are and to live life to the fullest. Success comes easily if you love what you do. Why? Because we are more relentless in our pursuit of goals about things that we love. If you hate your job right now, do you think you will ever be successful at it? Not in a million years! You may plod along, even become competent at the tasks, but you will never be a great success at it. You will achieve peak performance and do what you have to do to succeed only if you are doing something that interests you or something that you care about. Entrepreneurs who succeed do not mind the fact that they are putting in 15 or 18 hours a day to their business because they absolutely love what they do. Success in business is all about patience and hard work, which can only be attained if you are passionate and crazy with your tasks and activities.

c. ***Focus on your strengths.*** Let's face it; you cannot be everything to everybody. Each of us has our own strengths and weaknesses. To be effective, you need to identify your strengths and concentrate on it. You will become more successful if you are able to channel your efforts to areas that you do best. In business, for example, if you know you have good marketing instincts, then harness this strength and make full use of it. Seek help or assistance in areas that you may be poor at, such as accounting or bookkeeping. To transform your weakness to strength, consider taking hands-on learning or formal training.

d. ***Never consider the possibility of failure.*** As an entrepreneur, you need to fully believe in your goals, and that you can do it. Think that what you are doing will contribute to the betterment of your environment and your personal self. You should have a strong faith in your idea, your capabilities and yourself. You must believe beyond a shadow of a doubt that you have the ability to recognize and fulfill them. The more you can develop faith in your ability to achieve your goals, the more rapidly you can attain it. However, your confidence should be balanced with calculated risks that you need to take to achieve greater rewards. Successful entrepreneurs are those who analyze and minimize risk in the pursuit of profit. As they always say, "no guts, no glory."

e. Plan accordingly. You have a vision, and you have enough faith in yourself to believe that you can achieve your vision. But do you know how to get to your vision? To achieve your vision, you need to have concrete goals that will provide the stepping-stone towards your ultimate vision. Put your goals in writing; not doing so just makes them as intangible fantasies. You need to plan each day in such a way that your every action contributes to the attainment of your vision. Perhaps today, you need to see an artist to help you conceptualize the new line of hand-made linens that you hope to launch. Intense goal orientation is the characteristic of every successful entrepreneur. They have a vision, and they know how to get there. Your ability to set goals and make plans for your accomplishment is the skill required to succeed. Plan, plan and plan-because without which failure is guaranteed.

f. Work hard. Every successful entrepreneur works hard, hard and hard. No one achieves success just by sitting and staring at the wall every single day. Brian Tracy puts it out this way, "You work eight hours per day for survival; everything over eight hours per day is for success." Ask any successful businessperson and they will tell you immediately that they had to work more than 60 hours per week at the start of their businesses. Be prepared to say goodbye to after-office drinks every day, or a regular weekend get-away trip. If you are in a start-up phase, you will have to breathe, eat and drink your business until it can stand on its own. Working hard will be easy if you have a vision, clear goals, and are passionate with what you do.

g. Constantly Look for Ways to Network. In business, you are judged by the company you keep - from your management team, board of directors, and strategic partners. Businesses always need assistance, more so small businesses. Maybe the lady you met in a trade association meeting can help you secure funding, or the gentleman at a conference can provide you with management advise. It is important to form alliances with people who can help you, and whom you can help in return. To succeed in business, you need to possess good networking skills and always be alert to opportunities to expand your contacts.

h. ***Willingness to Learn.*** You do not need to be a MBA degree holder or PhD graduate to succeed in your own business. In fact, there are a lot of entrepreneurs who did not even finish secondary education. Studies show that most self-made millionaires have average intelligence. Nonetheless, these people reached their full potentials achieved their financial and personal goals in business because they are willing to learn. To succeed, you must be willing to ask questions, remain curious, interested and open to new knowledge. This willingness to learn becomes more crucial given the rapid changes in technologies and ways of doing business.

i. ***Persevere and have Faith.*** No one said that the road to success is easy. Despite your good intentions and hard work, sometimes you will fail. Some successful entrepreneurs suffered setbacks and resounding defeats, even bankruptcy, yet managed to quickly stand up to make it big in their fields. Your courage to persist in the face of adversity and ability to bounce back after a temporary disappointment will assure your success. You must learn to pick yourself up and start all over again. Your persistence is the measure of the belief in yourself. Remember, if you persevere, nothing can stop you.

j. ***Discipline Yourself.*** Self-discipline is the key to success. The strength of will to force yourself to pay the price of success - doing what others don't like to do, going the extra mile, fighting and winning the lonely battle with yourself.

4.3.4.5 Kinds of Entrepreneurs

? Can you identify kinds of entrepreneurs before reading the next section?

There are three kinds of entrepreneurs: inventors, modelers and marketers. All can be successful, but in may mind, only one kind of entrepreneur is on the surest path to building a business that survives… and thrives.

So what's the difference between the three? Well, keep in mind that the three terms 'innovators', 'modelers' and 'marketers' are just labels. Though, as you read the definitions, you'll get the distinction between each entrepreneurial type. And, generalizing – there are probably people who fit into each category in different situations.

a) ***'Innovators'*** tend to come up with solutions to problems people don't know they have, or for things people don't know they want. They have a great idea for what they think people will love and want, and then, without any evidence that people will love and want what they have to offer, go ahead and build it. Many of the highest-profile Internet companies were started by innovators – eBay, Youtube, Skype, MySpace, Face book and many others.

b) ***'Modelers'*** provide products and services for which there is a known and certain market. They work out what people are already buying and then seek to sell whatever that is. Their competitive advantage is to provide that product or service in a unique and better way than their competitors. A classic example of a modeler is a lawyer who decides to start a law firm.

c) ***'Marketers',*** like modelers, are market-driven. But they're not just interested in following the market. They want to lead the market as well. As business people they tend to begin as modelers and then, after achieving a degree of control of the market.

4.4 Production/Operation Management

Production/operations management is the process, which combines and transforms various resources used in the production/operations subsystem of the organization into value added product/in a controlled manner as per the policies of the organization. Therefore, it is that part of an organization, which is concerned with the transformation of a range of inputs into the required products having the requisite quality level. The set of interrelated management activities, which are involved in manufacturing certain products, is called as **production management**. If the same concept is extended to services management, then the corresponding set of management activities is called as **operations management**.

Activity: 3

1. **What are the sources of resources used in production?**
2. **Describe factors of production.**
3. **List the major categories of factors of production.**
4. **Explain labour as a factor of production.**
5. **What is the return of land as a factor of production?**
6. **Explain entrepreneurship as a factor of production. Give example of entrepreneurs in your localities.**
7. **What is the return to the entrepreneurship as a factor of production?**
8. **List the seven tasks of an entrepreneur.**
9. **Give a brief explanation of each task of an entrepreneur.**

4.5 Cost of Production

Define the concept of cost. Compare your answer with the next elaboration given for the concept of cost.

To produce goods, firms must utilize various resources (materials, labour, machinery, and building). To respond to a change in demand, firms must change the amount and/or type of resources used. To change resources, they must have time. We can identify two production periods the short run and the long run-to reflect the time required in order to change resources.

In the short run, a firm can change only variable, not fixed resources. ***Long Run*** *is the period of time in which a firm can change all its resources. A period of time in which a firm cannot alter all its resources is called* **Short Run.** In the long run, a firm can change all resources. In the short run a firm is unable to change all the resources it uses. For example, if a firm is deciding how much to offer for sale next week it will be unable to change the size of its factory and the number of machines it is using in time to affect quantity supplied. But with sufficient time, the firm could buy additional machines (or sell some) and build a large or smaller factory. Thus in the long run, a firm has enough time to change all the resources it uses. How long is a long run? The answer depends on the industry engaged in. For example a new gasoline service station can be opened for only a few months, but a new plant to generate electricity takes years to build.

For short run decisions we must recognize that a firm will have some fixed resources, which it cannot change. Machinery and buildings are typically among the firm's fixed resources. To change the output it produces, a firm must use more or less of its variable resources. Materials and labour can generally be considered as variable resources which can be changed in a relatively shorter period of time.

Variable Inputs *are resources that vary directly with output; that is, any increase in output requires greater use of variable resources.*

Fixed Inputs *are resources that in short run do not vary directly with output; that is, output can be increased (within limits) without using more fixed resources.*

Just as some resources are fixed and others are variables, so some costs are fixed and others are variables. A cost is defined as an expenditure usually of money, required for the purchase of input used in the operation of business.

Fixed Costs *are costs, which do not vary as output varies.*

Fixed costs are obviously associated with fixed resources, and include such items as rental payments on buildings, interest payments on loans, property taxes, depreciation costs etc.

Total fixed costs are constant, regardless of output, because in the short run a firm cannot change the quantity of its fixed resources. For example a firm has the same cost for rent of a building (say, birr 2000 a month) whether it produces 500 or 500,000 books in a month.

Variable Costs *are costs, which vary as output varies.*

Variable costs are associated with variable resources; they increase or decrease directly with total production in the short run. In contrast to total fixed costs, total variable costs are not constant because the amount of variable resources increases as total production increases and decreases. The total variable costs equal the quantity used multiplied by the unit cost of the variable resource. For example, if the material and other variable costs per book is 0.20 cents, the total variable costs of producing 500 pens is 100 (birr 0.20 x 500) and the total variable cost of producing 5000 books is birr 1000 (birr 0.20x5000).

Total costs are the sum of total variable and fixed costs. For example if a firm produces 5000 pens in a month, the total costs are birr 3000 – (or birr 1000 variable costs plus birr 2000 fixed costs).

When output is zero, total costs will be equal to fixed costs since variable costs will be zero. When production commences, total costs will begin to rise as variable cost increase. Total costs will continue to rise as production increases, because there must be some increase in variable costs as output increases.

Average cost is cost per unit- Average cost is computed by dividing total costs by the output. When output is small, average cost will be high because fixed costs will be spread over a small number of units of output. As output increases, average cost will tend to fall as each unit is carrying a smaller element of fixed cost.

The extra cost necessary to produce one more unit of output- the last unit-is called marginal cost. Marginal cost is the increase in total cost or variable cost as output rises by one unit. In practice, of course, many units are produced rather than by adding one units at time. Under such circumstances, the marginal cost is measured by the change in total cost divided by the change in the number of units produced.

The following table summarizes the nature of production costs, based on different units of output and the above assumptions of costs:

Variable cost per unit (pen) = birr 0.20

Fixed cost per month =birr 2000.00

Table 4.1 Costs of Production (In Birr)

Unit of Out put (pen)	Fixed Cost (In Birr)	Variable costs (In Birr)	Total Costs (In Birr)	Average cost (In Birr)	Marginal cost
0	2000.00	0	2000.00	-	-
500 pens	2000.00	100.00	2100.00	4.20	Birr 0.20
1000 pens	2000.00	200.00	2200.00	2.20	Birr 0.20
1500 pens	2000.00	300.00	2300.00	1.53	Birr 0.20
2000 pens	2000.00	400.00	2400.00	1.20	Birr 0.20
2500 pens	2000.00	500.00	2500.00	1.00	Birr 0.20
3000 pens	2000.00	600.00	2600.00	0.867	Birr 0.20

Fixed costs are usually related to a fixed input and tend to remain unchanged when the volume of business activity changes. Therefore fixed costs are represented by a horizontal line in graph to show that they remain constant as output varies.

Variable costs are the most important and most controllable costs. As explained earlier variable costs change in response to changes in the volume of business activity.

The variable cost line in the graph passes through the origin point '0' since there is zero cost incurred when zero unit of output is produced. In this illustration the variable cost line slopes upward to show the change as output increases.

? **Define the following terms and support your definitions with examples drawn.**

Long run cost
Short run cost
Variable resources
Fixed resources
Fixed and variable costs

4.5.1 Break-Even Analysis

The break-even point is the volume of sales needed to cover the company's total variable and fixed costs. It is a point where there is neither profit nor loss. When sales move beyond the break-even point, profits begin to generate rapidly and vice versa. Let's see how the breakeven point works in determining the profit of a business. It is assumed that variable costs vary proportionally with sales and that fixed costs will not vary regardless of sales volume. In the example, the following assumptions are made. Selling price of a unit is birr 100; variable costs 50 percent of selling price (birr 50) and the monthly fixed costs are birr 60,000. By using the following formula we notice that the business arrives at a breakeven point when it produces 1200 units or realizes sales of birr 120,000. If the company produces less than 1200units, it suffers a loss. When more than 1200 units are sold the company makes profit. The formula is given below.

$$\text{Break-even point} = \frac{\text{Fixed Cost}}{\text{Unit Price} - \text{Variable cost per unit}}$$

$$\frac{\text{Birr } 60{,}000}{100-50} = 1200 \text{ units}$$

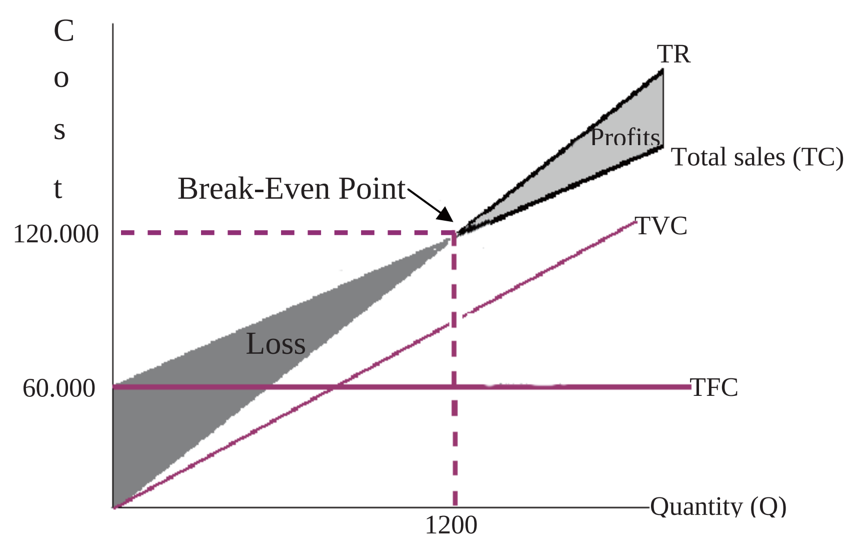

Figure 4.2 Graphical representation of cost of production

Activity: 4

1. **Describe short run costs that are related to change of resources of a firm.**
2. **What can a firm change in the short run as far as its resources are concerned?**
3. **In the long run, a firm can change all resources. Explain.**
4. **What is a breakeven point? Let us assume that you started producing shirts of high quality to be exported to Kenya. Your monthly fixed cost is 18000 birr. The unit price of the shirt is 150 birr. Your variable cost per shirt is 40 percent of the unit price. How many shirts do you have to produce to make profit? To break-even or to incur a loss.**

4.6 Location of Facilities and Infrastructure for Production Process

Business owners or managers today face many possibilities and complexities. They must balance numerous factors in the environment, i.e., markets, resources, utilities, site, in choosing a location for their business. The basic facilities, services, and installations needed for the functioning of a community or society, such as transportation and communication systems, water and power lines, and public institutions including schools, post offices, banks and prisons are called infrastructure.

Modern transportation and communication systems have broadened the range of potential business sites. At one time, it was nearly impossible to produce iron at any distance from ore deposits and charcoal sources because means of moving materials in any quantity did not exist. Today many such barriers can be overcome if there is sufficient reason to do so. In selecting a location, for the facilities for production process now managers or owners must balance a number of sometimes-conflicting needs. The major considerations are:

The availability of:

- transportation
- markets
- resources
- utilities
- site

4.6.1 Transportation

Transportation is defined as the movement of goods and persons from place to place and the various means by which such movement is accomplished. The growth, the ability, and the need to transport large quantities of goods or numbers of people over long distances at high speeds in comfort and safety has been an indicator of civilization and in particular of technological progress.

At present our world has seen remarkable advancements in transportation: by air, by sea, and by land. Trucks and automobiles, ships, trains and jet airplanes made communication over long distances much easier and quicker than ever before. New transportation lines also led to the development of remote areas throughout the world. Now a days, it is common to see pipelines, (used for transporting water and petroleum) included in the list of modes of transportation.

? **Can you identify how transportation affects the operation of business?**

Nearness to markets has an important influence on the location of facilities. Areas with high concentrations of people, such as Addis Ababa and Dire Dawa continue to attract number of business organizations. This is because of many buyers who can be reached with low shipping costs.

Moving close to markets is particularly important for producers of perishable products such as dairy products that are difficult and expensive to ship. Businesses that are required to provide services for their products, such as the producers of computers almost always select locations mainly on the basis of easy access to markets.

4.6.3 Resources

The availability of the resources a business uses often affects the choice of location of facilities for production. Being close to the sources of raw materials is important for many industries. Some industries use huge amounts of water and must establish their operations in areas where water is available. Industries that use partially processed materials, such as lumber, sheet metal, or component parts in their operations may benefit by locating their firms near these sources.

Labour is another resources that affects the location of facilities for production. Business that provide services often need highly skilled workers who are hard to find except in areas with concentrated populations. The same is true of many manufacturing processes that require laborers with highly developed skills. Businesses that use workers with skills that are easily taught are often attracted to areas with low average pay scales.

4.6.4 Utilities

Most industries today rely on large amounts of power for their operations. If coal or oil is used, it may be beneficial for the industries to locate near their sources. Prices are usually lower there because transportation costs are minimal. The cost of electric power purchased from the supplier (Ethiopian Electric Power Corporation-EEPC) also varies in price from place to place.

Some industries need places for disposal of solid or liquid wastes. In some places there are facilities capable of handling these problems. In other cases, a natural resource, such as a large body of water, may be needed for the disposal of treated liquid wastes.

Transportation is important to most business organizations. The availability of major highways, railways, airports or other transportation facilities play a role in business location. Communication facilities such as telephone, telex, etc are also important.

4.6.5 Site Availability

The other requirement of a good location of facilities for production process is availability and suitability of an appropriate building or site. A good site must be large enough for proposed operation. Space for parking and future expansion must be considered. The land itself should be suitable for building neither so soft as to require deep pilings for support nor so rocky as to require blasting. Finally, the price of the land or the right to use the land must be affordable.

Activity: 5

1. **What are the major considerations in choosing location of facilities for the production process?**
2. **How does the distance from markets influence location of facilities?**
3. **Explain how utilities affect the choice of location of facilities.**
4. **Indicates the modes of transportation you would prefer to use to transport each of the following goods and explain why?**
   a) **100 tons of hides and skin**
   b) **2000 cubic liters of crude oil**
   c) **20 tons of electronic equipment**
   d) **1000 automobiles from the port of Djibouti**
   e) **2000 quintals of Teff from Beshoftu to Addis Ababa**

Summary

- The needs and wants of people never stop. Most things that people need or want do not appear in nature at all. If needs or wants are to be satisfied, there must be production. Any activity which helps to satisfy needs and wants is defined as production. Production is the creation of utility. The most obvious way in which people add utility to material things is by changing their form. This is called form utility. By carrying products (goods) from where their supply is great to where their supply is small place utility is added to the goods. Storing goods from times of plenty to times of scarcity adds time utility.
- Production is the making of goods and services. Goods are the material things, which we use, in our everyday lives. Services on the other hand are non-material thing help to satisfy our needs and wants. The purpose of economic activities is the satisfaction of needs and wants. Economic activity results in the output of variety of goods services. The composition of total output is classified into consumer goods, producer goods and services.
- To produce a given product we require inputs. Inputs are the materials and services used in the production process. At the other end of the process are outputs, the goods or services that the firm produces for sale. The relationship between inputs and outputs in the production process is called production function.
- Production cannot take place unless the necessary resources are available. Factors of production are the inputs (resources) of land, labour, capital and entrepreneurship that a firm uses to produce outputs. Labour is the physical and intellectual exertion of human beings in the production process. Wages are the return to the labour factors of production. Land refers to all natural resources that can be used as inputs to production. Rent is the return to the land factor of production. Capital is the durable, but depreciable, input to the production process. Interest is the return to the capital factor of production. Entrepreneurship is the input to the production process that represents innovation and risk taking. Profit is the return to the entrepreneurship factor of production.
- To produce goods firms must utilize various resources. In the short run, a firm can change only variable-not-fixed resources. But in the long run, a firm can change all resources. Variable resources vary directly with output, while fixed resources; in short run do not vary directly with output. As some resources are fixed and others are variable, so some costs are fixed and others are variable. Fixed costs do not vary as output varies but variable costs vary as output varies.
- Business owners or managers face many possibilities and complexities. They must balance numerous factors in their business environment. In selecting a location for facilities for production process they must balance a number of conflicting needs. The major considerations are: the availability of markets, resources, utilities and site.

Review questions

Part I. Choose the best answer from the given alternatives.

1. _________ is an activity of people towards the creation of things.
   - a) Cost
   - b) Function
   - c) Output
   - d) Production
2. Which of the following denotes the production of services?
   - a) Operations management
   - b) Materials management
   - c) Productivity
   - d) Variability
3. The movement of goods and persons from place is referred as _______________
   - a) Facility
   - b) Production
   - c) Entrepreneurship
   - d) Transportation
4. Identify an items that cannot be considered as a capital
   - a) Tools
   - b) Machineries
   - c) Vehicles
   - d) Labour
5. A person who develops a new product, a new market or a new means of production is termed as:
   - a) Capitalist
   - b) Worker
   - c) Entrepreneur
   - d) Owner

Part II. Answer the following questions.

1. Explain the difference between fixed inputs and variable inputs?
2. Define production activities and support your definition by an example?
3. Your classmate Hawine said, "Production is the creation of wealth". What is your reaction to this statement? Do you support her or do you oppose the idea.
4. Define costs of production and give list of the points that should be taken into consideration when costs of production are discussed.
5. Discuss about the following terms and provide an example for each.
   - a. Natural resource
   - b. Labour
   - c. Capital
   - d. Entrepreneurship
6. Ojulu and Abebe, classmates of Grade 11B were debating over a point of starting a business. Abebe said to Ojulu "to start a business, all what it takes is to have capital and land. The rest is not that much important". Ojulu said, "No, the two alone will not be adequate to start a business, risk taking alone and labour are the other factors production that enable us to start a business."
   - a) What are the points missed in the statement of each student?
   - b) Whose statement is wrong or correct?

7. **Define the following terms and provide a mathematical example to support your definitions.**
   a) **Variable cost** c) **Fixed Cost**
   b) **Total Cost** d) **Marginal Cost**
8. **What are the factors that influence the choice of a location for the facilities of production process? Provide an example for each factor.**
9. **Explain each of the following terms and provide an example for each.**
   a) **Utility of form** c) **Utility of time**
   b) **Utility of Place** d) **Utility of possession**
10. **Identify a common product in your locality and explain how the following utilities are added to it.**
    a) **Form utility**
    b) **Place utility**
    c) **Time utility**
11. **Describe the production function of a product that is available in your school.**
12. **Visit a near by organization that produces product and identify its factors of production?**

Part III. Short Problems

To produce a pair of shoes, a shoemaker incurs birr25.00. The shoemaker also incurs birr500.00 of fixed costs per month.

Instruction: **Based on the data given above, answer the following questions:**

1. **Compute**
   a. **Total Variable Costs**
   b. **Total Fixed Costs**
   c. **Total Costs**
   d. **Average Cost**

   Assuming the shoemaker can produce, "0", 1, 10, 100, 200, 300, 400, 500, 600, 700, pairs of shoes in a month.

2. How many pairs of shoes have to be produced to incur birr 25.50 of average cost?

GLOSSARY

Accessory equipments *are capital items which refer to portable factory equipment and tools, which do not become part of the finished goods.*

Agency *is the delegation of authority to another person to act on one's behalf.*

Agent *is the person who is authorized to represent the principal in dealing with the third party.*

Analytical process is *a production process that breaks down materials into new and more useful forms.*

Article of co-partnership *is the written agreement by which a partnership is formed.*

Assembly process *is an industrial process which creates products by joining together component parts without changing their shape or composition.*

Assets *are any valuable property used for or resulting from a business. Examples of assets are cash and other material properties owned by the owner/s.*

Automation *is a collection of methods for controlling machinery and production processes by automatic means, sometimes with electronic equipment.*

Bankruptcy *is a legal procedure in which a court divides up the remaining assets of an insolvent person or company among the people and organizations to whom money is owed: when this procedure is applied all debts are erased.*

Bartering *is trading goods for goods.*

Boards of directors *are investors in the corporation who are elected by shareholders, who represent the stockholders and have final authority for all corporate actions.*

Bond *is a written pledge to a lender or lenders stating-the intention of the borrower or borrowers to repay a loan and specifying the principal, the date of maturity and the rate of interest.*

Business *is defined as all the activities for profit that satisfy human needs and wants by providing goods and services for a profit to maintain and improve our quality of life.*

Business cycle *is a period during which business activity and general employment alternatively rise and fall.*

Business environment *is the collection of the physical and cultural factors outside of the business system itself that influence the activities of business.*

Business income taxes *are taxes paid by the business enterprises based on profits remaining after all costs of operating business have been deducted.*

Business law *is a body of law that applies especially to the conduct of business activities.*

Capital *(1) any kind of wealth that is valuable to support the activities of producing goods and services, that is, of creating more wealth private money and resources which are used to pay for the cost of setting up and running a business.*

Capital intensive *is a production process in which equipment or materials are of primary importance: the activities of workers have a lesser significance.*

Capital items *are producer goods, which require large investments and last for longer period of time.*

Checking account *also called demand deposits are claims against a bank, which can be transferred by means of checks from one person or business to another.*

Check *is depositors written order directing a bank to pay out money from the depositors account.*

Command economy *is an economic system in which the government plans and controls economic activity and assessing available resources and social needs and then directing the manufacturing and distribution facilities of the country toward certain goals.*

Component materials *are manufactured materials, which require further processing.*

Component parts *are usually not processed by the manufacturer or the manufacturers do not change their forms. Component parts enter the finished products with no further processing as when tires are fitted to automobiles.*

Consumer goods *are those goods that are purchased by individuals for their personal or family use.*

Consumers *are people or individuals who buy products for their personal or family use.*

Continuous process *is the process of production in which the production runs for long periods of time. Sometime machines perform the same operations for months or years, and often the entire operation relies on the machines to keep running.*

Convenience goods *are goods that are bought by the consumer after little shopping effort, purchased frequently, bought by habit and sold in numerous shops.*

Convertible bonds *are type of bonds that can be exchanged for common stock at a rate specified in the bond.*

Cooperative *is a form of business ownership in which production, marketing or purchasing facilities are jointly owned by a group and are operated mainly to provide a service to members of the group rather than to make a profit.*

Copyrights *are the legal means of protecting one's ownership, which involves property created by the mind. For example copy rights protects literary, musical and dramatic works.*

Corporation *is an association of individuals, created under the authority of law which exists and has powers and liabilities independent of its members.*

Credit association *is a business organized as a cooperative that provides its members a means of saving as well as borrowing money.*

Culture *is the total collection of beliefs and ways of living that develop within a given society.*

Currency *is the cents and paper money that are used for exchange processes.*

Customs duties *are service taxes collected when goods are imported either by private travelers or commercial travelers.*

Custom products *are a products made to the customers' specifications and design.*

Debenture bonds *are unsecured type of bonds. They are issued based on credit standing of the issuer.*

Debt financing *is a fund raised by a business through borrowing, principally in the form of a bank loan or the sale of bonds.*

Deflation *is the decrease in price of goods without corresponding increase in productivity.*

Distribution *include all those activities involved in moving goods from their point of production to consumers or from the seller to the buyer.*

Dividends *are portion of the surplus profits of a corporation divided among its owners, or stockholders.*

Ecology *is the science that studies the interaction between living organisms and their environment.*

Economize *means to get as much from the resources available.*

Eder *is society for mutual aid and burial.*

"Ekub" *is thrifty or rotating credit society.*

Entrepreneur *is an individual who uses personal initiative to organize business activities.*

Equity financing *are funds raised by selling shares in its ownership.*

Excise tax *is a tax collected from the manufacturers or sometimes from retail sellers of certain products like beverages.*

Express warranty *is statement made by a seller, often in a written form, which the article being sold is of a specified quality and type. The warranty may also state the seller will repair or replace the merchandise when defects are found.*

Extractive process *is a type of production activity that takes physical resources from the earth, sea or air for use in further manufacturing or directly for consumers.*

Fabrication process *is an industrial process whereby the size or shape of materials are joined together in various ways to create new products.*

Factor of production *are the inputs of natural resources, labor and capital and entrepreneurship that a firm uses to produce outputs.*

Fixed costs *are manufacturing costs which do not vary according to the amount or the type of goods produced or services provided, but remain relatively stable, for example, rent and utilities.*

Franchise *is an independently owned company that pays a parent company a fee for the right to sell a certain product or to use certain methods of brand names.*

Franchisee *is the individual owner of the business who uses the trademark, know-how, and reputation of established firm.*

Franchisor *is the parent company that allows the franchisee to use its trade-mark, know-how and reputation.*

Free Market Economic System *is a term describing an economy in which businesses arc allowed to pursue their operations without central government planning or control.*

Goods *are material objects like tables or books that you can feel and see.*

Implied Warranty *is a warranty, implied by law even when it is not expressed by the seller, that in most sales the buyer is receiving clear ownership of the property and* *the seller is authorized to sell it, and that the goods are as represented and can be used for their intended purpose.*

Income tax *is a regular payment made to a government by individuals and organizations.*

Incorporates *are persons who are responsible for the initial organization of a corporation and who provide the initial assets for a corporation.*

Indirect distribution channel *is the path to markets followed by goods which pass through intermediaries (wholesalers, agents, retailers,) to the ultimate consumers of those goods.*

Individual needs *are needs of knowledge and self-expression.*

Industry *is a collection of all the businesses that perform similar operations to provide the same general kind of goods or services for example shoe industry.*

Inflation *is the increase in price of goods and services.*

Installations *are capital items which refer to buildings, machinery and fixed equipments and etc.*

Intermediaries *are an individual or business that performs some marketing functions in return for discounts from the producer or for markups when the goods are resold.*

Investment *is an expenditure of capital by an investor to establish for profit a new enterprise or to upgrade on that exists.*

Joint venture *is a form of business ownership set up by two or more companies to carry out a one-time, short lived business project, at the completion of which it ceases to exist.*

Labor intensive process *is a production process in which workers make a more significant contribution to the value of the output than does any other element in the production process, such as equipment.*

Lease *is the temporary control of real property.*

Liabilities *are money owed by a company for any reason, for example, borrowing or purchasing.*

Limited partnership *is a form of business ownership in which one or more partners are granted limited liability, provided there is always at least one partner with unlimited liability.*

"Mahber" *is an association for mutual aid on attachment to specific patron saint.*

Manager is *a person who performs the unique work of management planning, organizing, directing, and controlling an individual who works through the efforts of other people in an organization to enable the organization to meet its objective,*

Monetary transaction *is an exchange of products with money.*

Money *is a means of exchange which serves as a standard of value and also provides a convenient means of storing value.*

Mortgage bond *is type of a bond that is secured by property owned by the issuer of the Bond.*

Needs *are basic forces that move a person to do something.*

Non-profit enterprises *are enterprises, which do not seek a profit. Par value is price of a share.*

Partnership *is a business form that is owned by two or more people for profit.*

Patent *is an article that protects the invention or discovery of a new and useful process.*

Personal income tax *is a tax paid based on how much money individuals earn from employment and investments.*

Physical distribution *is all activities that are required to move products physically by carrying from the producers to consumers.*

Physical needs *are needs that individuals must have in order to survive.*

Premium *is a regular payment made by an insured into a pool maintained by the insurance.*

Producers *are those people and organizations that convert inputs to a more useful product for users.*

Producer goods *are those goods that are bought by individuals and organizations for further processing or for use in conducting a business.*

Production *is the process of converting resources into a form in which people need or want them.*

Production function *is the relationship between inputs and outputs in the production process.*

Profit *is the amount of money left from income made by selling goods and services after all the costs of producing the goods and services have been paid for.*

Property tax *are taxes paid on regular intervals and their amount is being based on a valuation of real or personal property.*

Protective tariffs *are taxes imposed on certain imported goods to reduce the amount of goods imported or substantially to raise the price of specific imported goods' to protect domestic producers.*

Pure risk is *a type of business risk, which refers to possibility of loss caused by accidental fire, injury or other damage to property or life.*

Raw materials *are producer goods, which are bought without being processed.*

Retailers *are a company or an individual who buys products for resale to ultimate consumers.*

Sales tax *is a tax payment for which the amount is determined by the value of products being sold.*

Saving account *is an account with a bank on which the bank pays interest to the depositor.*

Service *is any activity or benefit that one party can offer to another that is essentially intangible and which does not result in the ownership of anything.*

Share or stock certificate *is the evidence of ownership in corporations.*

Shopping goods *are consumer goods that are bought after comparing several features of the product.*

Social needs *are needs of belonging and affection.*

Sole proprietorship *is a form of business ownership in which a single individual assumes the risk of operating the business, owns its assets and controls and rises its profits.*

Specialty goods *are goods bought by the consumer after a special shopping effort: purchased infrequently and are sold in a few exclusive shops.*

Speculative risk is *a risk one whose consequences may be either favorable or unfavorable.*

Standard products *are items that are produced to their own* manufacturers. *Examples are automobiles, toothbrushes, soft drinks and etc.*

Stockbroker *is a person or company that represents investors in the buying and selling of securities.*

Supplies *are producer goods, which are consumed in the operation of manufacturing processes like lubricants, pencils, nails and papers.*

Synthetic process *is an industrial process which creates new materials by physically combining and changing other materials.*

System *is an organizational form or set of interrelated rules, procedures and the like. A system can be economic, social political, physical1 and so on.*

Technology *is the collection of methods a society uses to provide itself with material needs and wants.*

Trade channel or marketing channel *is the sequence of business enterprises through which a product passes on its way from producer to the final buyer.*

Trademark *is a mark that distinguishes goods supplied by a particular manufacturer or merchant from similar goods manufactured or sold by others.*

Transaction *is a unit of measurement in exchange.*

Utility *is the satisfaction consumers receive from items they acquire or from activities they engage in, or services they use.*

Variable costs *are costs which rise and fall according to changes in production activity or volume of output.*

Wants *are needs that are learned during a person's life.*

Warranty *is a legal assurance that goods or services being sold contain desirable characteristics.*

Wholesaler *is a business firm that buys goods in large quantity from different manufacturers and re-sale them in smaller lots.*