# BUSINESS SKILLS

## TRAINING COURSE FOR BENEFICIARIES OF MICROECONOMIC INITIATIVES

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# INTRODUCTION

## 1. Background

Since 2001, the International Committee of the Red Cross (ICRC) has been implementing income-generating programmes, or microeconomic initiatives (MEI), for vulnerable populations in dozens of contexts throughout the world. The beneficiaries of these programmes typically have very limited or no business management experience. Programme reviews and evaluations have revealed that basic business management training could help them set up and run their businesses properly, improving the chances that they will achieve faster and better results from their income-generating activity.

The decision was taken to devise a business skills training course to help MEI beneficiaries develop sound business ideas and formulate simple business plans. The course is intended to guide the beneficiaries step by step through the process of establishing the plan and makes them think through the different aspects of their business idea. It is also intended to provide them with simple tools to run their business, notably a simple record-keeping system.

This script constitutes a basic step-by-step business skills training course that can help the beneficiaries of MEIs develop and run their businesses.

The course is intended for applicants who have gone through the initial selection process for an MEI programme, i.e. all those who are deemed vulnerable, and who have the capacity and motivation to implement a business idea. Final approval for a grant should be given upon completion of the course and based on the business idea developed by the applicant.

It is important to note that course participants will benefit from the course irrespective of whether they are selected to receive a grant. They will leave the course with a stronger business plan and basic concepts and tools allowing them to better manage a future business.

## 2. Purpose of the course script

This script for the business skills training course provides course facilitators with the material they need to train MEI beneficiaries how to plan and run their businesses. It discusses a series of topics considered important for the fledgling entrepreneur and provides facilitators with background material, exercises and hand-outs.

The course script is designed to help the beneficiaries of an MEI programme run successful businesses. It treats the beneficiaries as starting entrepreneurs and is designed to provide them with basic skills and tools to start their business without burdening them with extensive theoretical concepts and complex models. During the training course, the beneficiaries will develop a clear understanding of their business idea, devise a plan to implement it, and receive some basic tools to run and monitor their business. The course is also intended to stir their entrepreneurial spirit.

During the course, the participants will:

- define and spell out their business idea;
- determine the strengths and weaknesses, the opportunities and risks presented by their business idea;
- learn about the importance of marketing and develop their own simple marketing plan;
- conduct a market assessment to gather the information required to plan and implement their business idea;
- estimate the income, costs and profit of their business idea;
- determine the capital they need to start the business;
- learn how to keep simple records; and
- integrate all the information acquired into a simple business plan.

By setting a benchmark, the business plan will help the beneficiaries to implement their business ideas and ICRC staff to select appropriate beneficiaries and monitor achievement of their objectives.

The course material is not to be delivered in a classical teaching style, where a trainer explains concepts and tools and the participants take notes and go home and try to apply what was taught. The course should not be "read" to the participants. It should be adapted to their educational level and context. Trainers should use simple language and a participative style to deliver the material. They should play the role of facilitators.

The participants will learn concepts and tools through discussion, exercises and activities. They should be motivated to bring in their own experience and discuss practical local examples. The purpose of applying an interactive training style is to adapt the course and its material to the participants' needs and immediate environment, to demystify the business world by making the participants realize that they are able to understand and interact with it, and to enhance comprehension and recall of the material acquired during the course.

The course calls for basic literacy and numeracy skills.[1] Course participants are asked to read simple texts and perform basic mathematical operations. Illiterate beneficiaries might be able to follow the course with the help of other participants, family members or friends with basic literacy and numeracy skills; however, they do need basic numeracy skills.

The script should be seen as a general frame for a business skills training course – a model. Delegates and field officers should adapt it to the local context. All examples can be altered and replaced. At the very least, the currency and names should be adapted to the context. Ideally, the case studies and examples should be replaced by local versions. The projects of former MEI beneficiaries are a good source of inspiration.

1 Completely illiterate and innumerate people need special training courses, which are too time-intensive to fit into a typical MEI programme. See, for example, FAO (1993a, 1993b, 1994a).

They make the course more realistic and motivating for the participants, who will find it easier to identify with the material.

The script is supplemented with a simple facilitation guide that illustrates how the training course can be organized.

## 3. Structure of the course script

The course consists of eight modules on various aspects of business management.

- Module 1 provides a general overview of what business is about. Using a simple case study, it illustrates the difficulties that can arise when implementing a business. It underlines the importance of planning and preparation before starting a business.
- Module 2 discusses the importance of having a properly defined and analysed business idea and basic entrepreneurial capabilities when setting out to run a business. It provides simple tools to draw up a business idea, assess entrepreneurial capabilities, and analyse a business idea.
- Module 3 gives a brief introduction to marketing. It points out the importance of the four Ps (price, products, promotion and place) and prompts the participants to start thinking about how they can sell their product and formulating a simple marketing strategy.
- Module 4 prepares the participants for an initial market assessment, allowing them to collect the information required to plan and assess their business. It discusses information needs, provides simple market information checklists, and presents some general recommendations for how to obtain good information.
- Module 5 shows the participants how to analyse the financial viability of a business idea using a simple case study and prompts them to assess their own business ideas.
- Module 6 shows the participants how to determine the capital needs of a business using a simple example and

prompts them to determine the capital needs of their own business.

- Module 7 introduces the participants to a very simple accounting system that will help them to run their business once they start operating.
- Module 8 helps the participants integrate all the information into a simple business plan.

Monluck Sidara/ICRC

## MODULE 1:

# INTRODUCTION TO BUSINESS

Module 1 starts with a brief overview of some basic business concepts and definitions to make sure all the participants have a common understanding of what doing business means. It continues with a case study that serves to illustrate the importance of a well thought-out business idea and careful preparation before starting a business. Finally, it provides two simple forms that help the participants formulate their business idea and assess their entrepreneurial capabilities.

# Session 1: Business basics

## 1.1 Key learning points of the session

In this introductory session, the participants will learn that:

- a business produces goods or services for customers for the purpose of generating a profit;
- to generate a profit, they conduct three basic activities: buying, producing and selling;
- to generate a profit, the income from the business activity must exceed its total cost;
- entrepreneurs must know the total cost of producing and marketing their goods or services;
- a business can only generate a profit if customers buy its goods or services;
- entrepreneurs must know the type of people they want to sell their goods or services to;
- entrepreneurs must know their competitors and their goods or services (i.e. quality and prices);
- entrepreneurs must know the infrastructure and market support services for their market;
- entrepreneurs must know the institutions, rules and standards that affect their business activity.

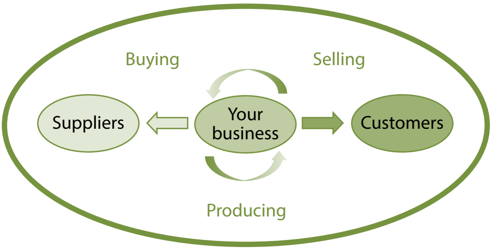
**Do not present** the key learning points at this stage of the session **but rather summarize** them at the end.

## 1.2 What is a business?

A business is a set of regular activities conducted by an individual or a group of individuals to generate profit by fulfilling the needs of other people. To generate a profit, businesses conduct three basic activities (see *Hand-out 2*):

- buying (equipment and materials)
- producing (goods or services)
- selling (goods or services)

*Diagram 1: Typical business activities*




Businesses can be categorized according to their nature (see *Hand-out 3*). A common way to do this is set out below.

(a) Agricultural business: If a person is growing crops or rearing livestock for sale, we say he is running an agricultural business. For example: Abdi is raising chickens to sell them on the market.

(b) Manufacturing business: If a person uses raw materials and his labour and tools, equipment or machinery to produce finished products, we say he is running a manufacturing business. For example: Jean is cutting palm leaves, braiding them into small mats, and selling them as roofing material in his village.

(c) Service business: If a person satisfies the needs of others using his skills and tools, equipment or machinery, we say he is running a service business. For example: Paul buys a motorcycle to provide transportation services to the people in his village.

(d) Trading business: If a person buys goods from producers and sells them on to others, we say she is running a trading business. For example: Dana buys vegetables from the farmers in her village and sells them to vegetable retailers on the market in the nearby city.

## 1.3 The business idea[2]

Every business activity starts with a business idea. Business ideas usually come from one's environment: you look at the people in your environment and identify uncovered needs or unsolved problems. This gives you an area for your activity. If you have the necessary skills to address these needs or problems, you may have found a business idea and an opportunity to start a profitable business.

Once an entrepreneur has found a business idea, he must analyse and elaborate it. A first step is to answer the four basic questions that define a business idea.

- What product or service will you sell?
- Who will you sell it to?
- How will you sell it?
- What customer needs will you meet?

When defining and putting together a business idea, it is crucial to consider the business environment, i.e. the market and market demand.

## 1.4 The business environment

Every business operates in a market – a specific business environment with its particular stakeholders (see *Hand-out 4*):

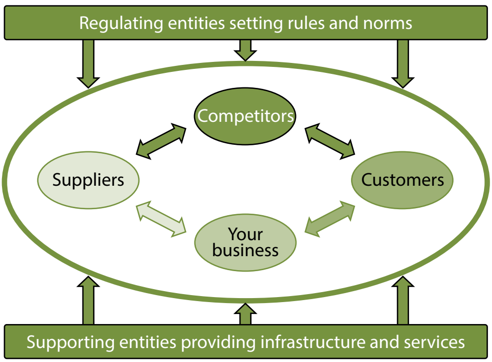
- suppliers, providing the inputs you need to operate your business;
- customers, buying your products or services;
- competitors, offering the same or similar products to the same types of customers;
- regulatory entities, such as government, tax authorities, etc.;
- supporting entities, such as providers of infrastructure, marketing boards, etc.

2 The following sections are adapted from IFRC (2001, p. 9).

In this script, the expression "market" refers to any organized exchange of a good or service between buyers and sellers. The concept goes beyond the physical market place in a village or town. Markets of varying types can spontaneously arise whenever a party has an interest in a good or service that some other party can provide. Hence, there can be a market for marbles at a school playground, a market for cold drinks on a hot day at a local sporting event, and yet another for the provision of money transfers. Markets come in a wide variety of forms: they can differ in scale, location, participants, infrastructure, governing institutions, etc.

The business environment can thus be interpreted as a system of stakeholders that together determine how goods or services are produced, exchanged and accessed. Diagram 2 is a graphic representation of a generic business environment.

*Diagram 2: Generic business environment*




To be successful in business, entrepreneurs must know their business environment and the market they want to target. They must know the suppliers of the inputs they require, the businesses competing with them, the different categories of customers for their goods or services, the rules and norms shaping the market, and the infrastructure and support services available.

The main duty of entrepreneurs is to make sure that all operational activities needed to provide goods or services to the customers are conducted as required and a profit is generated. To do so, they have to plan, organize, lead and control. This is called business management.

## 1.5 Market demand

Customers buy a good or service to satisfy a need or solve a problem; the key to a successful business is therefore a satisfied customer and not, as many believe, a superb good or service. If no one is willing to buy a business's goods or services, it does not have a market, however superb its goods or services may be. Without sales, a business cannot exist.

It is important to note that every new business starts without customers. It must convince people to buy its goods or services. It is therefore crucial for entrepreneurs running a business to know to whom they plan to sell their goods or services. They need to know their market.

A market can be divided into different market segments, with each segment representing a group of customers with particular characteristics. From a business's point of view, a market consists of specific customers who are willing and able to buy its goods or services. Take, for example, the market for locally produced traditional sandals for men in a small town.

Each market and each market segment works in its own particular way. The goods or services can be sold in different locations, at different times, in different manners, with different services, etc.

The entrepreneurs' first interest should be the needs and preferences of the people they want to sell their goods or services to. The most important question is: *What do the customers want?*

**The market for locally produced traditional sandals for men**

(see *Hand-out 5*)

*Market segment 1*: Local men with low incomes. Their product of preference is cheap footwear providing basic protection for their feet. They usually buy cheap, low-quality local sandals. Their main concern is the price. If they cannot find local sandals, they buy cheap imported plastic slippers. They mainly buy on the central marketplace.

*Market segment 2*: Local men with moderate incomes. Their product of preference is footwear that provides good protection for their feet, is durable, and, ideally, meets with local fashion and traditional standards. They usually buy locally produced or mid-quality imported leather sandals. They keep them for a long time and bring them to a shoemaker if they need repair. Their main concerns are price and durability. They buy in small shoe shops or directly from the producers.

*Market segment 3*: Local adults with high incomes. Their product of preference is high-quality local footwear. They almost exclusively buy traditional, locally produced, high-quality leather shoes and sandals. They buy several pairs and see shoes as a way to emphasize their social status. Their main concerns are exclusivity, design and quality. They buy their shoes in small shoe shops.

*Market segment 4*: Tourists and foreigners. Their product of preference is locally produced authentic footwear. They buy the leather sandals primarily as souvenirs. They almost exclusively buy quality sandals of traditional design. They buy primarily from the tourist shops around the hotels.

When defining and elaborating your business idea, you should ask yourself if there is a demand for the good or service you plan to offer. You should ask the following questions:

- What market and what market segments do I plan to target?
- What goods or services do customers in this market and in these market segments buy?
- What characteristics (e.g. types, quality) do customers require from the goods or services?
- What prices are customers willing and able to pay for these goods or services?

Finding the answers to these questions is called market research. It is an important step before opening for business.

When doing market research, entrepreneurs must always consider the competition. The competitors present in the markets and market segments they plan to target are competing for the same customers. If they want the business to succeed, they must be able to convince customers to buy their goods or services instead of those of their competitors. Customers always choose the goods or services at the prices they like the most.

Researching the market is a very important step on the way to a successful business and all entrepreneurs should invest the time and effort it requires. If market research reveals that the demand for their good or service is likely to be insufficient, they must modify their business idea or look for a new one.

## 1.6 Income, cost and profit

Every business generates income by selling goods or services. Income refers to the total amount of money that results from a business activity. In the case of a bakery, income is what customers pay for bread and pastries. The income generated by a business activity depends on the quantity of goods or services sold and the price they were sold for:

- Income = Price x Quantity

Every business activity involves costs. Cost is the economic value needed to acquire something. The cost of a business activity is the value of the resources that were consumed in order to generate the income. In the case of a bakery, the flour, yeast, sugar, butter and the oven used are costs. Salaries for employees and rent for the bakery are other costs. The time the entrepreneur invests in the business is also a cost.

Profit is the positive difference between the income that results from selling goods or services and the costs of producing them. A business generates profit when the income it generates exceeds the costs of running it:

- Profit: Income > Total cost

A loss is the opposite of a profit. It accrues when the costs of running a business exceed the income it generates:

- Loss: Income < Costs

A loss occurs when entrepreneurs put more money into the business activity than they get out of it – they are losing money.

**Exercise: Profit calculation** (see *Hand-outs 6 and 7*)

Every Tuesday and Friday, Magomed sells traditional sweets on the central market, where he rents a little market stand for $40 per week. The market fee is $12 per month.

Magomed wants to calculate the profit he made in the month of June. He keeps a record of all his sales and expenditures: he spent $120 on ingredients, $55 on packaging, and $22 for electricity. He also bought eight cardboard boxes for $5 each to transport his sweets to the market.

Magomed produces his sweets at home. On the two market days he takes a taxi to transport his output to the market and sell it. The taxi costs $7 each way.

Magomed sells small and large packages of sweets. In June he worked 8 days and sold 205 small packages for $2 each and 123 large packages for $3 each. Magomed was able to sell his entire June output.

Magomed's income for June was:
(205 small packages x $2) + (123 large packages x $3) = $779 income

Magomed's costs in June were:
(market stand 4 weeks x $40) + $12 market fee + $120 ingredients + $55 packaging + $22 electricity + (8 cardboard boxes x $5) + (16 taxi trips x $7) = $521 in costs

Magomed's profit for June was:
$779 income – $521 in cost = $258 in profit

*Note:*
*For participants with limited numerical skills, you can use* **Hand-outs 6a and 7a**, *which present a simpler example that refers to a single week.*

## 1.7 Maximizing profit (optional)

The purpose of a business is to maximize profit, not just to cover costs. Running a business is about generating maximum revenues at minimum cost. The higher the volume of sales and the greater the profit margin of a product, the more income a business activity generates.[3]

The profit margin is the positive difference between sales price and the total cost of a product:

- Profit margin: sales price – product cost

Thus, increasing the sales price or lowering the product cost will always improve the profit margin.

3 The term product is used to represent both goods and services.

Typically, small businesses produce products that are already available on the market and with limited possibilities for product diversification, that is, there are limited possibilities to modify the product in order to set it apart from other similar products or to improve its marketability and justify a higher price.

If a business cannot differentiate its product from other similar products on the market, the prevailing market price for that product or service sets the upper limit for the sales price. The lower limit is set, of course, by the cost of producing the product or service. Lowering costs is a good way to increase the profit margin but is often difficult to do.

Running a business requires a good understanding of all the costs entailed in producing and marketing a good or service. Without this understanding, it is not possible to determine whether the business activity is profitable or not.

The sales price directly affects not only the profit margin of a product, it also strongly influences the demand for that product, and therefore the volume of sales. Generally, the higher the sales price, the lower the volume of sales, and vice versa. Consequently, the level at which the sales price for a product is set has a considerable impact on the profit generated.

While the volume of sales depends first and foremost on demand, it also depends on the business's production capacity. The latter is determined by the extent of the resources (e.g. money, labour, time, availability of raw materials, etc.) the entrepreneur can put into the business. Entrepreneurs have to know their production capacity and the factors determining it; this will, *inter alia*, allow them to assess how easy it would be to increase capacity if their goods or services prove successful.

# Session 2: From business idea to doing business – a case study

This session consists of a case study that describes the difficulties one can encounter when implementing a business idea without having done the necessary groundwork. It discusses why and how many people choose to start a business, the risk of losing money, and the need for careful preparation and fact-finding before starting a business.

## 2.1 Key learning points of the session

This session makes several key learning points.

- Starting entrepreneurs require well-defined business ideas.
- Starting entrepreneurs must have the skills and capabilities to run the business they plan.
- Starting entrepreneurs must plan the business they want to run.
- Starting entrepreneurs must assess the market they plan to operate in.
- Starting entrepreneurs must gauge whether their business is profitable/financially viable.
- Starting entrepreneurs must know how to run a simple bookkeeping system.
- Starting entrepreneurs must decide how they are going to sell their products to customers.

**Do not present** the key learning points at this stage of the session **but rather summarize** them at the end.

If you want or need to adapt the case study, you should make sure the key learning points are touched upon in your version. An ideal example to illustrate the key learning points would be a real microeconomic project that failed and that the trainer is familiar with.

An experienced trainer may also illustrate the key learning points by taking different examples from projects of previous beneficiaries, discussing them, and pointing out the importance of the key learning points.

## 2.2 From business idea to doing business – case study

The case study forms the starting point of the actual training course. It is intended to awaken everyone's analytical capabilities and to provide a basis for discussing key points to consider before starting a business.

### Nathalie's chicken business – a case study

(see *Hand-out 8*)

Nathalie lives with her husband Tom and their two daughters in a small village 15 km from the provincial capital. Tom has his own carpentry workshop and makes furniture. Orders for furniture dropped significantly with the start of the conflict, and so did the family income.

Nathalie decided to start a poultry project to improve the family's income. She had the idea because her neighbour Joan was running a successful little chicken business. Joan was raising broilers and layers and selling the broilers and the eggs on the provincial market. Nathalie figured that Joan must make a lot of money since she managed to cover her family's expenses all by herself.

Nathalie talked to her husband and told him that she wanted to start her own chicken business. Tom liked the idea. Together they decided that Nathalie would raise broilers because this seemed easier and promised quicker revenues. However, Nathalie and Tom had no experience raising chickens.

Nathalie found a supplier of day-old chicks. He told her the minimum order was 50 chicks at $1 per chick and that she would have to pay cash on receipt. Nathalie told the supplier that she wanted him to deliver 50 chicks one week later to her home. She went back home to prepare the old shed in her yard to accommodate the chicks.

She bought a few dishes and attached upside-down plastic bottles to sticks next to the dishes so that the water in the bottle would refill the drinking dish. She also made some feeders and pegged them to the ground. She added an old oil-burning oven to warm the shed and keep the chicks warm. The material and the oil for the stove cost her $45. Then she went to the market to buy chicken feed. The trader on the market advised her to buy "broiler starter feed" for the first four weeks and "finisher feed" for the last weeks. This would give her nice and fat broilers in a short time. The trader told her the feed would cost $200 for her batch of 50 chickens. Nathalie thought the special feed was expensive and decided to buy maize instead. She spent $150 on maize and decided she would feed the chicks more.

When the supplier delivered the chicks, Nathalie paid him the $50 they had agreed on. She put the chicks in the shed, lit the oil-burning oven, and put it on the lowest position because oil was expensive and she did not want to increase the cost of her project more than necessary.

Nathalie checked on her chicks several times a day. She noticed that the chicks tried to get close to the oven and even started fighting for the best spot. She decided to put her laying hens in the shed, too, because she believed they would keep the little chicks warm and stop them from fighting.

After a few days, Nathalie noticed that some chicks looked weak. After one week, she found several chicks dead. She was disappointed because this would decrease her income. Nathalie did not know what to do. She wondered whether the chicks had been delivered sick. When she found some more chicks dead the next day she decided to talk to a local trader selling veterinary products.

The trader asked her many questions, but Nathalie did not tell him that she was feeding her chicks maize. She told him that she had put her laying hens in the shed to help keep the chicks warm. The trader said that this was probably the problem. The chicks could have caught an infection from the chickens. He recommended buying medicine. Nathalie spent $9 on medicine.

Back home, Nathalie immediately removed the laying hens from the shed, gave the medicine to the chicks, and turned up the oven. She did not want to lose more chicks.

Nathalie was relieved when she saw that the remaining 38 chicks finally started to gain weight. After three weeks she was convinced that she would lose no more chicks. Although Nathalie did not know what size chickens should be at different ages, she was disappointed at their size at that point.

Nathalie knew that broilers were usually sold at six weeks, so when her chickens were six weeks old she decided to bring them to the provincial market. She went to her neighbour Chris, who had a large van and asked how much he would charge to transport the chickens to the market. Chris said he would do it for $37. She agreed and asked him whether she could pay him after she had sold her chickens, as she was out of money. Chris made an exception and agreed. Nathalie also needed some large crates to transport her chickens. Chris said he would rent her eight large boxes for $1 each.

The next day Nathalie went to the market. There were other people like her selling chickens and their chickens looked much larger and fatter than hers. After Nathalie had unloaded her chickens the woman next to her asked how old the chickens were. When Nathalie told her they were 6 weeks old, the woman looked very surprised and asked why they were so small. Nathalie was worried.

Then the customers started coming. They checked the different lots of chicken and immediately realized that Nathalie's chickens were smaller than the others. One man laughed and said her chickens were so small, she should provide her customers with fodder to feed them. The owner of a restaurant told her that he could not buy her chickens for his restaurant because his customers would not want to eat skinny chickens like that and he bought all the chickens of the woman next to Nathalie for $8 each.

Nathalie realized that she had to lower the price of her chickens to sell them. But even when she offered them at $4, she was only able to sell 20 chickens. She decided to try and sell the remaining 18 chickens in her village. Fortunately, Chris did not charge her for transporting the chickens back because he had to bring back his boxes anyway. Back in the village, Nathalie was able to sell 12 more chickens at $3 each. She decided that she would keep the remaining ones for her family.

At the end of the day, Nathalie calculated how much money she had made. She realized that she had only earned $116 and she hadn't even paid Chris yet! When her husband came home, Nathalie told him that her project was a complete failure as she had spent more than she had earned. Tom asked how much she had lost. Nathalie said she had no idea but that her housekeeping money was all gone.

## 2.3 Discussion of the case study

There are a number of possible conclusions to draw from the case study (except for question (2)). The aim of the case study is to have the participants think about implementing a business and develop their own view of what is required to start a business. The following box shows possible answers for guidance.

The answers under (4) constitute the outline for the remainder of the training course (see *Hand-out 1*). This is one possible way to prepare to run a business. It is not the only one.

## Nathalie's chicken business – case study answers (see *Hand-out 9*)

*(1) Nathalie was looking for a way to improve the family's income. Looking around her, she found a business idea. She decided to copy the idea of her neighbour, who ran a successful chicken business.*

*(2) Possible answers:*
- *Nathalie did not have the necessary skills and knowledge for the business project and did not inform herself.*
- *Nathalie did not prepare and plan.*
- *Nathalie did not conduct any market research and did not know what customers wanted.*
- *Nathalie did not know the possible income and costs of her business.*
- *Nathalie did not keep any records of her business transactions (she did not know how much money she had lost).*

*(3) Possible answers:*
- *Nathalie consulted with her husband.*
- *Nathalie followed the development of her business (chicks).*
- *Nathalie looked for help when chicks started dying.*
- *Nathalie tried to minimize her loss by lowering the price she was asking for her chickens.*

*(4) Before starting your business you have to:*
- *formulate a properly thought-out business idea;*
- *assess whether you have the skills and knowledge to implement and run the business;*
- *develop a clear understanding of the business and plan how you want to run it;*
- *assess the business environment you are planning to operate in;*
- *assess your potential income, costs and profit;*
- *put in place a system for keeping records and managing your finances;*
- *decide how you will reach customers.*

*(5) Income: (20 chickens x \$4) + (12 chickens x \$3) = \$116*
*Cost: (50 chicks x \$1) + (\$45 material) + (\$150 maize) + (\$9 medicine) + (\$37 transport) + (8 transport boxes x \$1) = \$299*
*Loss: \$116 income – \$299 cost = – \$183*

*(6) Yes, if she had used the proper feed (assuming that no chicks had died):*
*Income: (50 chickens x \$8) = \$400*
*Cost: (50 chicks x \$1) + (\$45 material) + (\$200 feed) + (\$37 transport) + (8 transport boxes x \$1) = \$349*
*Profit: \$400 income – \$349 cost = \$51*

# Session 3: Planning a business

Many businesses fail because of lack of planning – Nathalie's chicken business is a prime example. Planning is thus an essential step on the way to a successful business. This session is dedicated to the subject of planning a business. It starts with a short explanation of why planning is important and then discusses what things need to be planned when starting a business. Finally, it presents a simple business plan format. As the subsequent training modules cover the different subjects of the business plan, at the end of the training course, the participants will have a basic business plan.

## 3.1 Key learning points of the session

This session makes several key learning points.

- Planning helps entrepreneurs understand what they need to do and get.
- Starting entrepreneurs must plan their buying, producing and selling activities.
- Planning helps entrepreneurs obtain a good understanding of their business, solve problems before they actually occur, and reduce the risk of loss.

**Do not present** the key learning points at this stage of the session **but rather summarize** them at the end.

## 3.2 Introduction to planning

Planning can be described as the thinking that takes place before the action. As the previous case study illustrated, entrepreneurs needs to plan their business before they get started. They must address two basic questions.

- What do I need to do?
- What do I need to get?

The first question helps entrepreneurs plan the tasks needed to operate the business. The second question helps them determine the equipment and materials – the resources – needed to operate the business.

The difficulty for starting entrepreneurs is that they have to establish their business plans based on a business idea, initial market estimates and financial projections instead of existing business data. This makes establishing a business plan more difficult.

## 3.3 What needs to be planned?

As mentioned earlier, every business conducts three basic activities: buying, producing and selling. It is these basic activities that need to be planned, along with all the ensuing business relations, notably relations with suppliers, employees and customers (see *Diagrams 1* and *2*).

The list below presents a selection of aspects that typically need to be considered when planning a new business.[4] Addressing these questions systematically and sequentially is called planning, and the final answers to the questions become the business plan. A good business plan helps entrepreneurs to:

- obtain a good understanding of their business
- solve problems before they actually occur
- reduce the risk of loss
- prepare for possible difficulties
- develop self-confidence.

A business plan is an essential document for starting a business and making it successful. It provides information on the type of business, the market the business is going to operate in, the way in which the business is going to produce its goods or services, the costs of operating the business, the way the business is financed, and the profit the business is expected to generate.[5]

4 The following is adapted from BDS (2008d).

5 See, for example, CISP (2011, p. 70), CARE (2010, p. 51), ILO (2009b), and BDS (2008a, p. 26; 2008d, p. 8).

**Typical questions when planning a business**[6] (see *Hand-out 10*)

***Questions to plan tasks***

- Who will buy the equipment and materials needed?
- How will the equipment and materials be transported to the production site?
- What activities need to be conducted to produce the goods or services?
- How much time does each of these activities take?
- Who will conduct the activities?
- Who will sell the goods or services?
- Where will they be sold?
- How will the goods or services be brought to the customer?
- How much time will it take to sell the goods or services?

***Questions to plan resources***

*General questions*

- What equipment and material do I need to operate my business?
- How much equipment and material do I need to operate my business?
- How much does the equipment and material cost?
- When do I need to buy the equipment and material?

*For equipment and tools*

- What equipment and tools are required?
- How much of the equipment and how many tools are needed?
- Do all these items have to be bought or can they also be rented or borrowed?
- When are the items needed?
- How much does each item cost?
- How much money do I need for the items?
- How much does it cost to bring the items to the production site?
- What does it cost to maintain the equipment?

*For raw materials*

- What raw materials do I need?
- What quantities are needed to produce the planned amount of goods or services?
- When are the items best bought?
- How much does each of the items cost?
- How much money is needed to procure the materials for one production cycle?
- How much does it cost to transport the items to the production site?

*For other inputs*

- What other inputs are needed to operate the business?
- How many of these items are required?
- When are these items best bought?
- How much do these items cost?

*Selling costs*

- How much does it cost to transport the goods and services to the market?
- Are there fees or other costs to pay to operate the business (taxes, licences, etc.)?

6 Adapted from CARE (2002). See also BDS (2008d).

Establishing a business plan forces starting entrepreneurs to assess all the subjects that are of importance when running a business (see previous case study).

Once established, the business plan can be used as a road map during the business implementation phase. It can provide guidance and serve as a reference when problems occur. To be of use, the business plan needs to be simple and as accurate as possible.

Starting entrepreneurs do not have all the information they need from the very beginning. They have to collect it. Establishing a business plan is a process and requires time. The better the plan, the easier it will be to implement the business later on. It pays to invest time in establishing and elaborating it.

Business plans are also excellent tools for communicating with investors and suppliers interested in understanding the business's operations and goals. They can be used to illustrate the business's financial viability and thus to raise the necessary capital or to obtain credit from suppliers.

### 3.4 A simple business plan format

To be of use for the course participants, the business plan must be as simple and straightforward as possible (see *Hand-out 11*). The main steps for setting up a business plan are:

- describe the people involved
- describe the business idea
- present a SWOT analysis of business idea
- describe the market
- prepare a marketing plan
- estimate the sales
- determine your equipment needs and costs
- determine your material needs and costs
- determine your utility and infrastructure needs and costs
- determine your labour needs and costs
- determine your administrative and selling costs
- estimate your capital requirements
- conduct an income and expenditure analysis
- estimate your profit.

NOTE: Hand-out 48 *contains a simple business plan that the facilitator can use as a reference at this point. However, it should not be distributed to the participants at this point in the course because it might overwhelm them. Only its structure should be discussed in simple words*.

The above outline is only intended to illustrate what is going to be discussed. The participants are not expected to understand all the steps at this point.

The different subjects of the business plan will be discussed in the following modules. They are all crucial aspects that need to be considered when planning to start a business. Step by step, the modules will help the participants to develop the information needed to complete the plan. By the end of the training course, they should have a complete business plan for their own venture.

As the business plan offers a complete description of the participants' businesses, it is also a useful document for the ICRC staff who have to work with the participants and monitor the progress of their business ventures.

Leila Satueva/ICRC

## MODULE 2:

# DEFINING AND ASSESSING A BUSINESS IDEA

Module 2 is about the business idea. The participants start by learning how to define and develop their business idea. Next, they are introduced to the capabilities that are of use when implementing and operating a business. Lastly, they are introduced to the concept of SWOT analyses and learn how to use it to analyse the potential of their business idea.

## Session 1: Defining a business idea

This session discusses the importance of the business idea. The participants are provided with a simple tool that can help them to formulate and develop their business idea. They will apply the tool to a simple case study, which will serve as a reference for their own business idea.

### 1.1 Where can business ideas come from?[7]

Business ideas usually come from the environment: you look at the people in your environment and identify uncovered needs or unsolved problems. People who want to start a business should:

- observe the people in their environment and talk with them;
- consult with entrepreneurs already in business;
- study existing businesses to identify problems and think about ways to solve them;
- study products that are brought to the area from the outside and see whether they can provide them locally;
- study the raw materials available locally, in order to get an idea of what can be produced locally;
- get ideas from existing products on the market;
- observe other markets and areas for new business ideas;
- discuss with friends and family.

### 1.2 What is needed for a good business idea?

A business starts with a well-defined business idea. Entrepreneurs need to know what goods or services they will sell, who they will sell them to, how they will sell them, and what

7 For detailed presentations on business idea generation, see CISP (2011, p. 58), ILO (2009a), CEFE (2008) and FAO (1999a, p. 8).

customer needs they want to meet. The form below is intended to help starting entrepreneurs formulate their business idea. It is the first step towards their future business (see *Hand-out 12*).

The form helps future entrepreneurs reflect on their ideas and develop them. The better they know what they want to do, the easier it will be to fill in the form. In this sense, filling in the form is a first test of whether they are ready to go through with their business idea. They might realize that they need additional information. In that case, they should go out and get it before they continue on the path of starting a business.

Developing the business idea is an important preparatory step for a functioning business.

**Business idea form** (see *Hand-out 12*)

**Name of the business:**
*(What do you want to call your business?)*

**Location of the business:**
*(Where will the business be operated and what are the available facilities like?)*

**Goods or services the business will provide:**
*(Be as specific as possible when noting the goods or services you plan to provide.)*

**Customers the business will sell to:**
*(Be as specific as possible when noting the customers you plan to sell to. Consider and mention eventual market segments.)*

**The way the business will sell its goods or services:**
*(Explain how you plan to reach customers. Where and how are you going to sell your goods and services to them?)*

**Needs of the customers the business will meet:**
*(Note the specific customer needs or problems you plan to address.)*

A good way to check whether a business idea is well defined and consistent is to discuss it with family members, friends or other business people.

## 2.3 How to formulate and develop a business idea

The following case study provides an example of how a business idea can be formulated. It is the story of Baboukar, who is planning to start a tailoring business. The example is intended to underline the detail that is required when developing a business idea for the first time.

**Baboukar's tailoring business – a case study** (see *Hand-out 13*)

Baboukar has a wife and two children and lives in Ziguinchor. He used to earn his living working as a tailor in a local garment factory. Six months ago the factory went bankrupt and all of its employees lost their jobs. To make ends meet, Baboukar started to work as a daily labourer on construction sites. There is little work available, however, and he finds it difficult to earn enough.

One day Baboukar heard about an economic support programme run by a non-governmental organization (NGO). He learned that the NGO was providing people like him with financial support to start a small business. He contacted the NGO and was informed that he would be eligible for support if he could provide a well-defined, developed and convincing business idea. The NGO provided him with a form to help him draft his idea.

Thus, Baboukar began looking for a business idea. He figured he should use his tailoring skills and start his own tailoring business. He decided he would have to offer several products and services to succeed. He figured that he should target two market segments of people buying locally produced clothes: middle-income people buying ready-to-wear-clothes in the little clothing shops located in and around the central market, and high-income households buying locally produced tailored clothes. Baboukar believed that this would provide him with a fair amount of work.

To make sure that he could earn enough money to provide for his family, he also decided to offer alteration and mending services. He figured that some middle-income households might be interested in altering the ready-to-wear clothes and that poorer households would be interested in having their clothes mended instead of spending money on new ones.

Baboukar decided that he would sell the ready-to-wear clothes to the little shops in and around the central market, because that was where most people bought their clothes. The tailored clothes, on the other hand, he would sell directly from his tailoring workshop, as the people who bought them would have to be measured and fitted. He would also alter and mend clothes at the workshop.

To keep his costs low, Baboukar decided he would rent a little shop in a cheaper neighbourhood near the central market and transport his ready-to-wear clothing to the little shops on the central market using his bicycle.

The box below shows one way to develop Baboukar's business idea; it is by no means the only way. You can make additional assumptions and add more detail if you wish. For example, Baboukar might realize that high-income households do not want to shop for their clothes where less wealthy households bring their clothes for mending, and might thus be prompted to open a showroom for high-income households in the centre of town.

Remember: the better a business idea is defined, the easier it will be to implement it later on. It pays to invest time in this process.

**Baboukar's business idea – case study answers** (see *Hand-out 14*)

**Name of the business:**
*Passion for Fashion*

**Location of the business:**
- *Small workshop in Tana district, 15 minutes on foot from the central market*
- *Located on one of the main roads leading to the central market*
- *The shop includes a small showroom to receive customers*
- *Rent will be $150 per month*

**Goods or services the business will provide:**
- *Ready-to-wear clothes in all sizes for men, women and children (ages 6 to 16)*
- *Tailored clothes for men, women and children of all ages*
- *Alternations of all types of clothing*
- *Mending of all types of clothing*

**Customers the business will sell to:**
- *Shopkeepers selling clothes in Ziguinchor*
- *People living in the area around the workshop*
- *People in Ziguinchor interested in tailored clothes*
- *People in Ziguinchor interested in alterations and mending*

**The way the business will sell its goods or services:**
- *Ready-to-wear clothes will be produced and delivered to the shopkeepers in Ziguinchor according to their orders.*
- *Customers passing by can buy ready-to-wear clothes directly from the workshop at a discount.*
- *Tailored clothes will be sold exclusively through the workshop. Customers will pass by to be measured and place their orders.*
- *All alterations and mending will be done directly at the workshop. Customers will bring in the clothes and pick them up once they are ready.*

**Needs of the customers the business will meet:**
- *Shopkeepers in Ziguinchor need clothes to sell to their customers and customers appreciate locally produced clothing.*
- *Private customers living in the area of the workshop appreciate the possibility to buy clothes on good terms in the neighbourhood.*
- *Private customers who desire individual clothing or special sizes need tailored clothes.*
- *Private customers who want alterations need those services.*
- *Private customers who cannot afford to buy new clothes every time a garment tears need an affordable mending service.*

Entrepreneurs are unlikely to completely define and develop their business ideas at this stage. On the path towards their own business they will probably collect new information that will require them to adapt their ideas. This is not a problem. Defining a business idea is a process. What is important is that they consider the new information and adapt their business accordingly.

As stated earlier, the business idea is part of the business plan. It explains what the business is about.

# Session 2: Entrepreneurial capabilities[8]

This session describes and discusses the importance of entrepreneurial capabilities. Participants are provided with a simple tool to help them to assess their respective entrepreneurial capabilities.

## 2.1 Capabilities needed to run a business

Not everyone has the skills and abilities to succeed at every type of business. It is therefore important for entrepreneurs to identify their trade according to their skills, abilities and interests, the three factors that are usually of critical importance for the success of a business endeavour.

Different studies have revealed that the entrepreneur's qualities are an important factor of business success. Some of the capabilities that are generally considered to have a positive impact on an entrepreneur's business success are listed below.[9]

- *Moderate risk-taker:* A business is an uncertain endeavour. It does not necessarily work out as planned and there is always the possibility of loss. Successful entrepreneurs take moderate calculated risks in which their skills and capabilities play a major role (e.g. an entrepreneur will carefully judge his investment and not put all his assets at risk).
- *Self-confident:* Successful entrepreneurs have confidence in themselves and are confident about their capabilities. If you do not believe in yourself, how can others believe in you?
- *Goal setter:* Successful entrepreneurs plan their work. They define where they want to go and how they want to get there.
- *Curious and analytical:* Successful entrepreneurs are open-minded, interested, and alert to any information regarding their business field. Moreover, they have the

8 Based on BDS (2008, p. 4), ILO (2009a) and UNESCO (1999, pp. 82) [the UNDP reference is not in the list of references].

9 See ILO (2009a) for a more detailed discussion of the qualities of successful entrepreneurs.

capacity to analyse and interpret the information they obtain.

- *Opportunity seeker:* Successful entrepreneurs always look out for new opportunities – for ways to improve or enlarge their business.
- *Innovative:* Successful entrepreneurs are always trying to improve their business and their products according to the needs of customers. Innovation sets them apart from competitors.
- *Patient:* Starting businesses require time to become successful. Successful entrepreneurs must be patient and ready to confront problems on their way to success. They must take the time to address and solve problems and slowly improve their business.
- *Decisive:* Doing business is about taking decisions. Successful entrepreneurs manage the daily operations of their business and address all problems that occur along the way. They take timely decisions and are not afraid of the consequences. They take responsibility for their decisions.
- *Able to learn from experience:* Successful entrepreneurs learn from past experiences and adapt their behaviour if required. They see past failures as opportunities to learn and prevent future mistakes.
- *Emphasis on efficiency and customer satisfaction:* The purpose of a business is to make a profit. This is only possible if the business's products please customers. Successful entrepreneurs make sure they provide their customers with the quality they demand in the most efficient way, i.e. using as few resources as possible.

## 2.2 A simple tool for assessing capabilities

Entrepreneurs must check whether they have the entrepreneurial capabilities (skills, personal characteristics and personal situation) needed to operate a business. The box below presents a few important factors all entrepreneurs should consider before deciding to start a business.

**Your personal entrepreneurial characteristics** (see *Hand-out 16*)

**Your skills:**

- Do you have the practical abilities to produce the goods or services?
  *For a tailor, this means being able to design, measure, cut out and sew clothes.*
- Do you have the management skills to operate your business?
  *This means knowing how to sell goods or services (salesmanship), calculate costs and keep records.*
- Do you have knowledge of your line of business?
  *This means knowing your business environment – suppliers, competitors, customers, regulatory entities (rules, standards), supporting entities (services, infrastructure).*

**Your personal characteristics and situation:**

- Do you have the commitment to operate a business?
  *This means being willing to make your business your priority, work long hours, and risk your money in the business.*
- Do you have the motivation to operate a business?
  *This means you have to be keen on operating the specific business. You have to be interested in the business itself and not just in earning an income.*
- Are you ready to take a risk?
  *This means being prepared to take the moderate risks a business involves and that cannot be avoided. Can you take the risk of the business failing?*
- Are you able to take decisions?
  *This means being ready and able to take decisions in difficult situations, rather than leaving decisions to someone else.*
- Does your family situation allow you to operate a business?
  *This means asking whether you have your family's support for the business and whether your family obligations leave you time for the business.*

**Your financial situation:**

- Can you afford to engage in a business that may require time before it generates income?
  *Do you have funds you can put into your business? Do you have access to financing?*

While entrepreneurs do not need to score strongly on all of these characteristics, they must at least have the practical skills needed to produce the goods or services they want to produce. If not, they can change their business idea or put it on hold until they have acquired the necessary practical skills, for example in a vocational training programme. They should plan for the time required. Other ways to develop capabilities are:

- seek help from others (e.g. family, friends, other business people, support services);
- observe others doing business and try to learn from them;
- attend training programmes on business-related subjects;
- hire a skilled person permanently or an advisor temporarily;
- consult the literature (manuals and books; the ICRC can refer you to suitable documents).

# Session 3: How to assess a business idea

This session discusses the importance of analysing a business idea and provides participants with a simple tool that can help them analyse their business idea. They will apply the tool in a simple case study. This example will serve as a reference when they apply the tool to their own business idea.

## 3.1 Introduction to SWOT analyses

Once the business idea has been defined, it is time to subject it to a first analysis and see if it is competitive and potentially profitable. One way of doing this is to assess the *strengths* and *weaknesses* of the business idea and the *opportunities* and *threats* of the business environment. This approach is known as the SWOT analysis.

By specifying the business idea's objective, the entrepreneur identifies the internal and external factors that are favourable and unfavourable to achieving that objective. These factors are commonly depicted in a 2x2 matrix consisting of the four quadrants *Strengths*, *Weaknesses*, *Opportunities* and *Threats*.

**SWOT ANALYSIS - ILLUSTRATION** (see *Hand-out 17*)

| | **Favourable / Helpful** | **Unfavourable / Harmful** |
|---|---|---|
| **Internal factors** | STRENGTHS<br>*(positive factors on which to capitalize)* | WEAKNESSES<br>*(negative factors to be eliminated)* |
| **External factors** | OPPORTUNITIES<br>*(to seize)* | THREATS<br>*(to avoid/to take into account)* |

To determine the strengths and weaknesses of a future business, entrepreneurs need to look at the factors making up their business idea and at their personal situation. These are the factors that they can control – hence *internal factors*. Strengths are positive factors increasing the chances of success and on which they should capitalize. Weaknesses are negative factors reducing the chances of success and which they should try to eliminate. Note: entrepreneurs need to analyse their strengths and weaknesses in the light of their specific business idea.

To determine opportunities and threats to a future business, entrepreneurs need to look at factors that may influence the business but that are beyond their control. These are called external factors because the entrepreneurs cannot influence them – they are a given. Opportunities are things that may have a positive impact on the future business and which should be seized. Threats are things that may have a negative impact on the future business and which should be avoided or prepared for.

Entrepreneurs should take account of the following when conducting a SWOT analysis:

- the management and operational skills required to run the business;
- the financial needs of the business;
- the situation on the target market;
- the supply of inputs/materials needed;
- the infrastructure and physical assets required ;
- government policy, regulations and the social environment.

The following list presents typical factors that should be looked at when analysing a business idea. Note that the list only provides examples and is by no means exhaustive. If entrepreneurs find that other factors are important for the business idea, they should definitely include them in the analysis. Conversely, if they find that some of the factors below are not important for the business idea, they should just ignore them.

**Reference list for a SWOT analysis**[10] (see *Hand-out 18*)

| | |
|---|---|
| *Management and operational skills required* | |
| Management competence<br>Age/experience<br>Skills availability<br>Technical know-how | Management contact/network<br>Salesmanship of owner/staff<br>Personnel management skills |
| *Financial situation of the business* | |
| Amount of money needed to run the business<br>Amount of money needed for equipment<br>Owner of the money needed | Access to additional money<br>Profitability of the business<br>Financial risk of the business |
| *Situation on the target market* | |
| How is the market organized?<br>Competitors' strategy<br>Potential sales<br>Required quality of the product | Market: growing, stagnating or contracting<br>What is, was and will be the market demand?<br>What is, was and will be the supply situation?<br>Social acceptance of the good or service |
| *Supply of inputs/ materials needed* | |
| Adequate supply (price, quality, quantity) | Reliability of adequate supply |
| *Required infrastructure and physical assets* | |
| Work place<br>Machinery and technology<br>Location | Transport facilities<br>Infrastructure and utilities |

Entrepreneurs should consider the factors that they have information on and attempt to obtain information on what they do not know. During the course of the business planning process, they will collect additional information. As they do, their knowledge about their business environment increases and they will be able to refine their assessment of the quality of the business idea.

Once entrepreneurs have identified the strengths and weaknesses of the business idea and the opportunities and threats that it may face, they have to decide whether the objective, i.e. the implementation of the business idea, is attainable or not. They have to draw a conclusion. A SWOT analysis can help them decide whether they should:

- continue with the business idea and conduct a full feasibility study;
- adapt the business idea; or
- abandon the business idea.

10 Adapted from BDS (2008a, p. 8).

Conducting a SWOT analysis forces entrepreneurs to think critically about the business idea and improve their understanding of it. It can also help them identify further steps they have to take to achieve their objective.

### 3.2 An example of a SWOT analysis

The box below contains a SWOT analysis for Baboukar's business idea. Participants can use it as a reference when they have to assess their own business idea.

**SWOT analysis of Baboukar's business idea** (see *Hand-out 19*)

| **Strengths**<br>*(positive factors on which to capitalize)* | **Weaknesses**<br>*(negative factors to be eliminated)* |
|---|---|
| • *He has years of experience in tailoring ready-to-wear and tailored clothing.*<br>• *He knows the quality of clothes people like.*<br>• *In his previous job he had contact with customers and developed some sales skills.*<br>• *He knows where to find suppliers for fabric and other materials.*<br>• *He can continue to work as a daily labourer in construction until he has enough work as a tailor.*<br>• *He does not need much material to start.*<br>• *He has a bicycle to transport his products.* | • *He has no business management experience.*<br>• *He has no network in the business environment he plans to operate in.*<br>• *He has no money to invest in his business.*<br>• *He has no equipment to start his business.*<br>• *He does not know where to get machines.*<br>• *He does not know many shopkeepers.* |
| **Opportunities**<br>*(to seize)* | **Threats**<br>*(to avoid/to take into account)* |
| • *Since the garment factory went bankrupt, hardly any clothes are being produced locally.*<br>• *The cheap second-hand clothes worn by the poor often require minor mending and alterations.*<br>• *There are no tailors in the area where he plans to open his shop.*<br>• *Many tailors lost their jobs when the garment factory closed; it is easy to employ tailors.*<br>• *Shopkeepers prefer selling local clothes because of the higher profit margin.*<br>• *Rich people prefer tailored local clothes.* | • *Other former tailor colleagues might have the same idea and start a tailoring business.*<br>• *Nothing prevents tailors from opening their own shops in the same area.*<br>• *Cheap imported second-hand clothes are very popular, particularly among poorer people.*<br>• *The economic situation is not very good and more and more middle-income people are starting to buy cheap imported clothes.* |

# Homework

Describe your business idea (*Hand-out 15*).

Assess your business idea (*Hand-out 20*).

*Note: If you think that the participants cannot manage to do all this in two days at home, you can ask them just to describe their business idea and introduce an extra session at which each of them has a chance to present his/her idea so that it can be assessed in a plenary discussion. Be aware that this may not be possible in all contexts, as people may feel shy about having their project discussed in public.*

*Another possibility is to group people with similar project ideas and have them assess their ideas together (also in an extra session).*

Aslan Bzhikhatlov/ICRC

## MODULE 3:

# MARKETING PRODUCTS

Customers buy products to satisfy a need or solve a problem. Satisfied customers are the key to a successful business. Without sales a business cannot exist. This underlines the great importance of knowing how to sell products to people, i.e. how to market products. This module is dedicated to the subject of marketing: it introduces the concept, explains the central topics of interest when conducting market research, and presents the principal marketing parameters and illustrates how they can be combined.

# Session 1: The basic concept of marketing

This session begins with a general overview of what marketing is. It then discusses the information that is required to market products and the points to take into account when doing so. The points are important building blocks of marketing and important for participants to understand.

## 1.1 The concept of marketing

When entrepreneurs define their business idea, they determine what product they want to produce and whom they want to produce it for. They also have to decide how their product is best presented and sold to potential customers.

The objective of marketing is to make products appealing to customers in order to sell as many of them as possible. To achieve this objective, entrepreneurs obviously have to know what their target customers desire. They have to research the market (see also Module 3). Marketing is about many things, including:

- finding out what customers want;
- creating good will in the marketplace;
- providing products of satisfactory quality;
- choosing a good distribution mechanism;
- finding the best way to inform potential customers;
- determining business hours;
- designing appealing products;
- designing appealing packaging;

- enquiring about customers' opinions;
- motivating customers to come back;
- trying to make the business's products unique;
- choosing a competitive pricing strategy.

The better entrepreneurs define what market segments they want to target and whom they intend to sell their goods to, the better they can focus their marketing activities. This is another reason why a well-defined business idea is so important.

## 1.2 What information is required?

The following short exercise will reveal whether the participants are familiar and at ease with the concept of market research. It is a good opportunity for them to discuss what they have learned so far.

**Market information exercise** (see *Hand-out 21*)

The following four short business descriptions serve as a basis for a group discussion about what type of market information is required to be able to market the products concerned in the best possible way.

**A. Food stand**
Dan plans to open a food stand in his hometown.

- What market information does he need before he starts his business?
- How and where can he get the information?

**B. Small kiosk**
Talia lives in Gola and plans to open a kiosk in her district town. She wants to sell various everyday products (biscuits, candy, batteries, soap, oil, etc.) to the people living in the district.

- What market information should she collect before starting her business?
- How and where can she get the information?

**C. Bicycle repair shop**
Jack wants to open a bicycle repair shop in Dayton. He would like to serve cyclists throughout town.

- What market information should he look for before starting his business?
- How and where can he get the information?

**D. Chicken fattening business**
Mustafa wants to expand the chicken fattening business he is running in his village and start selling broilers on the central market in the neighbouring district capital.

- What type of market information should he collect before increasing production?
- How and where can he get the information?

## 1.3 Subjects of interest

The central marketing subjects of interest for an entrepreneur are: customers, product, costs and competition.

**Customers – target the business's customers**

- Who are the target customers?
- What do the customers do (e.g. housewives, businessmen, farmers)?
- Where are they located and where do they shop?
- What are they willing and able to pay?

**Product – the goods or services the business wants to sell**

- What products is the business offering?
- What is the volume of demand for these products?
- What makes the business's product special?
- Is there a demand for the business's specific product?

**Cost – the cost of producing and selling the business's products**

- What are the total costs of the product (i.e. direct costs, indirect costs, depreciation)?
- What will the selling costs be?

**Competition – the businesses offering similar products on the same market**

- Who are the competitors?
- Where are the competitors located?
- What are their prices?
- What are the characteristics of their products?
- How do they market their products?

Market research is an ongoing activity. Entrepreneurs must continuously observe the parameters of interest and stay on top of developments in their markets. This allows them to spot changes and gives them the opportunity to adapt their businesses. Based on their market research, entrepreneurs create and adapt their business marketing strategy, i.e. the way in which they want to promote their products.

# Session 2: The four Ps of marketing

Once entrepreneurs have researched the market, they have to develop a marketing strategy for their products. They have to decide how they want to attract customers. There are four basic features an entrepreneur can manipulate to influence the attractiveness of a product:[11]

- the product itself,
- the price of the product;
- the promotion of the product; and
- the place the product is sold.

Product, price, promotion and place are known as the four Ps of marketing. This session discusses each of these four Ps.[12]

## 2.1 Product

A product is a good or service intended to satisfy a customer want or need. Customers buy a product *inter alia* because of its specific characteristics:

- nature (e.g. customers who want footwear may want sandals because they are airy);
- design (e.g. customers may have a preference for "pointy" hats);
- packaging (customers may only buy food if it is packaged in plastic);
- quality (customers may only buy low-quality clothing because they have little income);
- size (customers may prefer small melons to large ones);
- taste (customers may only like white maize and not buy the yellow variety);
- colour (some customers may like bright colours, others may prefer white);
- brand name (customers may have a preference for a particular brand (e.g. Maggi)).

There is no objective way to define these characteristics. Entrepreneurs do not have to produce the best product on the market; what is important is that the quality of the product

11 See also ICRC (2009, p. 139).
12 See also BDS (2008b).

meets customer expectations. Customers tend to look at different aspects for different products. While they may focus on quality and workmanship when buying a chair, because they do not want it to break when they sit on it, they may focus on design and colour when they buy a shirt.

Entrepreneurs have to find out what their target customers consider important in a comparable product. Once they know this, they should shape their product as much as possible according to the customers' preferences.

Shaping and improving a product's characteristics requires effort and costs money. It should only be done if it helps sell the product and/or increases the profit to be made by selling it. If an entrepreneur enhances the quality of the product at significant cost but cannot sell more of it as a result of the improvement, then the improvement was not worth the effort. The entrepreneur bears more costs for the same amount of income, but generates less profit than before the improvement.

The best sources for information about product quality improvements are customers. Entrepreneurs should ask their customers and their competitors' customers what they think about the product's quality and characteristics and how they felt using it. They should note their comments and suggestions.

The products sold by small businesses often resemble each other. If many businesses offer the same or similar products, they will tend to saturate the market, i.e. there will be more products than there are people to buy them. This means that not all businesses will be able to sell all of their products. It also means that there will be pressure on the price of the product. If customers can choose among many suppliers and all suppliers offer exactly the same product, customers will go for the cheapest product. Suppliers know this and will try to offer lower prices than their competitors to sell their products.

Consequently, entrepreneurs are chiefly interested in differentiating their products from those of other suppliers. If you are selling products that are similar or identical by nature to your competitor's – let's take vegetables as an example – you can make sure you deliver consistent quality by grading the vegetables according to their quality. In this case, the products are not just vegetables but properly quality-graded vegetables. Quality-sensitive customers are likely to choose your produce over other vegetable suppliers because of the superior quality vegetables on sale, while poorer clients may visit your stand for cheaper, lower-quality vegetables than those they find at the stands of other suppliers.

## 2.2 Price

The price of a product is the value customers have to pay to acquire it. It is of central importance in selling. Customers compare the price of a product with the value it gives them. It is the perceived value the customers see in the product that determines whether they are willing to buy it.

The sales price strongly influences the demand for a product and therefore the volume of sales. In general, it can be said that the higher the sales price, the lower the volume of sales and vice versa. The level at which the sales price for a product is set has a considerable impact on the income generated. In some situations a business can increase its income by raising prices; in others it will have to lower its prices to increase its income. The difficulty is to find out in what situation a business is. An entrepreneur might try to find out by making small price changes.

Typically, a business will produce products that are already available on the market and there are limited possibilities for product diversification (see 1.6 *Maximizing profit*). This means that, in most cases, the prevailing market price for a product provides the upper limit for setting the sales price. Entrepreneurs need to assess at what prices the product they plan to sell is presently sold.

The lower limit for the price of a product is given by the product's total costs. If the product is sold at a price that does not cover its total costs, the business will generate a loss.

Because every business's aim is to generate a profit, entrepreneurs should try to set prices in a way that maximizes profit. The optimal price level depends on:

- the product's characteristics and production costs;
- the customers' willingness and ability to pay; and
- the prices of any competitors.

Price reductions are a common marketing tool. However, their extent (i.e. duration or applicability) should be clearly limited. Examples for pricing strategies are:

- discounts for loyal customers (limited applicability);
- low introductory prices (limited duration);
- rebates for large quantities (limited applicability);
- seasonal rebates (limited duration).

Price reductions should be based on a clear strategy and have a clear aim. Discounts for loyal customers can be introduced to show gratitude and to bind them to the business. Low introductory prices can make people aware of a product and motivate them to try it out. Rebates for large purchases can be offered if such purchases incur fewer costs than retail purchases or if doing so motivates customers to buy larger quantities. Seasonal rebates can be given if the seasonal availability of alternative products reduces sales (e.g. you may give rebates for umbrellas in the dry season and increase prices in the rainy season when demand is high).

## 2.3 Promotion

Promotional activities are intended to facilitate exchanges between a business and its customers. The aim is to make people aware of the products offered by the business. This involves:

- publicity
- sales promotion
- advertising
- packaging
- branding.

Entrepreneurs should define an appropriate mix of these activities for their business and product.

*Publicity* is the result of public service announcements or news generated through the media (e.g. radio, television, newspapers) or on public announcement boards. The business or its products are discussed in interviews, articles, magazine stories, etc. It means the business or product is rated by third parties.

*Sales promotion* is an activity that is specifically designed to induce sales by increasing the value for the consumer. Often this is done through volume discounts or special rebates. The aim is to attract new customers to convince them about the quality of the product. Another way is to offer free trials: a business selling food products can offer free samples of its new creations to customers and see if they like them.

*Advertising* is a form of impersonal broadcasting of information often conducted through commercial mass media (e.g. radio, television, newspapers). A business spreads a certain message and information on its products to attract customer attention. Leaflets and posters at strategic locations (i.e. locations potential customers often pass) are a cost-efficient way to inform customers about a business. When advertising a product, a business presents the advantages of its product itself. It tries to describe it in the most favourable way.

*Packaging* is an important but often forgotten marketing tool. Appropriate packaging can increase the functionality of a "product". For example, if an entrepreneur selling eggs provides his returning customers with plastic egg boxes, he may have a selling advantage over competitors who only provide plastic bags or old carton boxes. A good container can communicate convenience and reliability. Alternatively, the entrepreneur could offer home delivery for large volumes.

*Branding* is the activity of putting a name on the product. The idea is that people can easily identify the product. In developed economies, most customers are brand-oriented; they will buy a particular brand of vegetable oil and a particular brand of shoes. They do so because they had good experiences with these products and because they do not have time to check all available products all the time. Branding is a way of making your product identifiable. For someone running a small business, it may mean making the product recognizable and putting contact information on the product so people can identify who produced it. For example, a business producing dumplings and selling them to little shops and supermarkets should make sure consumers can identify its product easily so they can find it without difficulty when they return to the shop the next time. The contact information could be useful if the business is also selling directly to end-consumers. It would allow consumers to identify the business and shop there.

## 2.4 Place

The place refers to the location of a business. Location can have a strong impact on sales volume. A kiosk selling candy next to a school or playground is likely to sell more candy than a kiosk located in an industrial zone next to a power plant. However, place also refers to the way in which the business intends to bring its product to the customer. For example, is the product to be sold from a market stand, door to door, on a street near a strategically chosen location, or to wholesalers on a wholesale market?

Entrepreneurs should choose a location that is affordable, close to the customers and as far from the competitors as possible. However, there will always be trade-offs. There are plenty of aspects to evaluate when choosing a business location.

- Is it close to the customers?
- Is it far enough from the competitors?
- Is it adequate for my needs?
- Is it reasonably priced?
- Do I have access to the facilities and infrastructure I need?
- Is the location safe?
- How far do I have to commute?

If an entrepreneur is planning to open a retail shop, being close to customers may be the prime consideration. Good locations for retail shops are often expensive, so the entrepreneur must assess whether the potential extra sales justify the extra cost. Again, there are always trade-offs and choices must be made.

Entrepreneurs who need a production site and who will sell products to retailers – such as a carpenter producing chairs and selling them to retailers – may be happy with a cheap location that offers sufficient space to work and good transport connections. They need to weigh different factors when choosing the optimal location.

## 2.5 Other aspects

There are various other aspects that influence how attractive your product is to your customers. Examples are:

- the behaviour and competency of the sales personnel;
- the cleanliness of your premises;
- the opening hours.

# Session 3: The marketing mix

## 3.1 The marketing mix

Entrepreneurs have to consider all four Ps when determining their marketing plan, i.e. the way in which they plan to reach their customers. They need to:

- decide on a product that appeals to the customers;
- set a price the customers are willing to pay;
- choose a place that allows them to reach the customers;
- find a way to inform and attract customers.

The following table presents all the aspects that need to be considered when defining the marketing mix.

| **Aspect of the marketing mix** | (see *Hand-out 22*) |
|---|---|
| **Product** | **Price** |
| • Product range<br>• Quality<br>• Conception<br>• Packaging<br>• Maintenance<br>• Service<br>• Warranty<br>• Return policy | • Competitors' prices<br>• Pricing strategies (e.g. introductory prices)<br>• Prices for different market segments<br>• Pricing of alternative products<br>• Sales and promotions |
| **Place** | **Promotion** |
| • Distribution channels<br>• Strategic location<br>• Attractiveness of the shop<br>• Infrastructure and facilities<br>• Transport facilities<br>• Supporting services | • Advertising<br>• Sales personnel<br>• Sales promotions<br>• Branding and identifiability<br>• Packaging |

## 3.2 Marketing mix quiz

The following marketing mix quiz is a playful way to familiarize participants with the four Ps and prompts them to think about practical local examples.[13] Participants have to answer the questions, explain their answers and provide local examples to collect points.

13 Adapted from CEFE (2008).

## Marketing mix – quiz

(see *Hand-out 23*)

### Product

(1) Customer demand for a product always stays the same.
FALSE: *It can change because of seasonal variations, new competitors entering the market, changing circumstances, etc.*

(2) If your product sells poorly when you introduce it, you should immediately stop producing it because customers do not want it.
FALSE: *Introducing new products to the market requires time. First customers have to become aware of the product and try it. If the product satisfies the customers' needs and is of good quality, sales are likely to increase with time. Remember, an entrepreneur needs patience.*

(3) Testing your product on the market by selling a limited quantity for a limited time is a waste of time and effort. You should directly start production in order to be able to sell large quantities.
FALSE: *If you bring a new product to the market and do not know how customers will react to it, it is a good idea to conduct a market test before you actually invest time and money in producing large quantities. An entrepreneur must take moderate, calculated risks.*

(4) You should try to make your product special and different from others.
TRUE: *You should make your product as unique as possible – create an identity. However, the identity has to please customers.*

(5) Your product must try to attain the highest quality to sell well.
FALSE: *Your product should meet the needs of your customers. Therefore, its quality should be according to their needs.*

(6) Name two good ways to find out what customers want.
ANSWER: *Ask customers during a survey or observe them when they are buying products.*

(7) A market analysis is done to see if there is a market for your product. Once you have identified that this is the case, you do not have to worry about the market anymore.
FALSE: *Entrepreneurs must constantly keep an eye on the market as conditions can change all the time.*

(8) Selling products that are similar to those of competitors is not profitable.
FALSE: *There are many products that are sold by several businesses at the same time and they would not operate if they could not make a profit. However, in markets with many competitors profit margins tend to be smaller and it therefore becomes all the more important to control costs.*

(9) Customers choose repair services based on the reputation of the shop.
TRUE: *Customers often choose repair services according to the reputation of the shop. Providing quality repairs that are affordable will improve your reputation.*

(10) You must try to process your product as much as possible and use high-quality packaging to increase its value and your profit.
FALSE: *You should produce a product that you can sell at an interesting profit. Processing products and adding packaging means additional costs. The question is whether you can sell the processed and packaged product at a sufficiently high price to increase your profit.*

## Price

(1) It is always a good idea to sell your products cheaper than the other sellers in your area.
FALSE: *You can lose money if you set your price too low, even if you sell more products. You must always consider your costs when you set your price.*

(2) Your price should cover your production and selling costs, generate adequate profit, and attract customers.
TRUE: *The difficulty is to set the price accordingly.*

(3) If you charge more than other sellers, customers will not buy from you.
FALSE: *Customers do not only consider the price, they also consider the product itself, the service, customer relations, the location of the shop, etc. (e.g. a customer may buy fruit at a more expensive market stand if the quality is always good and the service very friendly).*

(4) It is difficult and risky to compete with large businesses on the basis of the price of a product.
TRUE: *Large businesses usually produce larger quantities, which allow them to realize economies of scale. Small businesses should compete on others aspects, such as quality, individual service, location, uniqueness, etc.*

(5) Adding a profit margin to the total cost of your product is a good method.
ANSWER: *Yes, but you have to take into account the customers' willingness to pay and the prices of alternative products on the market.*

(6) If you sell high-quality chairs and a new seller starts to sell cheaper, low-quality chairs, you should lower your price to keep your customers.
FALSE: *You should first change your promotion method to emphasize the quality of your product. If you realize that people prefer low-quality cheaper chairs, you should adapt your product, which reduces your costs, and then lower the price.*

(7) Your profit depends only on the price you charge.
FALSE: *It also depends on your costs, the customers' perception of your product and their willingness to pay, the presence of other products, and other things.*

(8) Setting your price below the total cost of your product is risky.
FALSE: *You will lose money over time. However, you may decide to do this if you are promoting a product, or if you expect production costs to decrease as a consequence of increased sales.*

(9) Your profit should always be at least 10% of your product cost.
FALSE: *There is no fixed rule regarding the profit margin. Your profit margin depends on the price you can ask for your product and the cost of producing it. You will typically try to sell your product for as high a price as possible.*

(10) It is important to review the price of your product on a regular basis.
TRUE: *As market conditions change, your product price may need to be adapted.*

## Promotion

(1) Promotion means creating a good image for your product.
TRUE: *It also means making customers aware of the product.*

(2) Promotion does not generate any costs and is therefore the best way to increase sales.
FALSE: *Promotion generates costs and these costs should be taken into account when you calculate the total costs of your product.*

(3) Good promotion explains your product in detail.
FALSE: *Good promotion emphasizes the strengths of your product in a simple way so that people are attracted to it and remember it (e.g. a bicycle shop will not promote its services by describing the technical features of the tools it uses or the bicycles it sells; it will describe its bicycles in a simple way that interests customers. For example: "Our bicycles are made with the highest quality components and never break down – and if you ever experience any bad luck, our repair staff is there to provide you with excellent service .").*

(4) Word-of-mouth is overrated and has no influence on the business.
FALSE: *A business reputation depends strongly on satisfied customers. Satisfied customers will talk about the quality of your business to others! Word-of-mouth does bring new clients. Note: unsatisfied customers also talk about their experiences!*

(5) Promotion involves two decisions: what you want to communicate and how you're going to communicate it.
TRUE.

(6) Your promotion should be honest about the benefits of your product.
TRUE: *If you communicate things that are not correct, customers will be disappointed and feel cheated. This may even result in bad word-of-mouth!*

(7) Free product samples are too expensive for a small business and should only be offered by large businesses.
FALSE: *This depends, among other things, on the product. If you sell a low-cost, low-priced product, free samples do not involve a huge cost and may motivate customers to try it.*

(8) This is a good marketing slogan: "Our chickens are so big, they can feed a family of 6!"
TRUE: *It passes information that shows customers how they benefit from the product.*

(9) This is a good marketing slogan: "Our chickens are fed with good-quality natural grains!"
FALSE: *It does not tell customers how they benefit from the product.*

(10) A business place that looks clean, interesting and appealing can attract customers.
TRUE: *The way a business presents itself is an important aspect of promotion.*

## Place

(1) Selling your products yourself requires time but it is cheaper than hiring someone and thus always worth it.
FALSE: *Your time is a cost, too. In some cases, the time you spend selling products means that you cannot produce them. In that case, it may be worth hiring someone to do the selling for you.*

(2) Adequate storage facilities are very important for a business.
TRUE: *If you have goods that need to be stored, you need proper storage facilities. What is adequate depends on your product. Examples: protected against theft, spoilage, water, etc.*

(3) Many businesses lose part of their stock because of poor storage facilities.
TRUE: *Storage facilities are important, particularly if a business requires large stocks of material.*

(4) It is always more interesting to sell your product to the end-consumer and not to use middlemen, who only cost money and lower your profit.
FALSE: *Middlemen may have a comparative advantage in transporting and selling your product to the final customer. It may be more expensive for you to do the same thing. Moreover, middlemen may help you to increase your sales as they are also interested in getting more business.*

(5) The greater the distance to your customers, the more interesting it becomes to cooperate with middlemen.
TRUE: *Transportation and storage costs normally increase with distance to the customer. In that case, it can be advantageous to sell the products at a lower price to middlemen who have the infrastructure to bridge the distance and store the goods.*

(6) Middlemen are always too expensive.
FALSE: *Middlemen provide a service. They have to cover their costs just like all other business people. As long as their services are cheaper than doing it yourself, it may be worth the price.*

(7) How to distribute your products is an important marketing decision.
TRUE: *The best way of distributing your products depends on the type of product. If you produce bespoke clothes, you will not sell them in bulk through market shops that specialize in selling second-hand clothes. If you produce large quantities of tomatoes, you are likely to find a wholesaler to sell your products instead of selling them yourself on the market.*

(8) Usually you can save money on distribution if you limit the number of people between you and the final customer.
TRUE: *Every additional intermediary needs to be paid, while the price the customer is willing to pay for the final product remains the same.*

(9) It is always best to place a shop in the most central place where a maximum of clients pass by.
FALSE: *Central places are good for certain commodities. They are also expensive. You may have to spend a lot of money to have your shop in a central location and if your product does not generate enough profit you may not be able to cover those costs. In that case, you will have to settle for a more affordable and less central location.*

(10) Producing goods at home is not a feasible option when starting a business because it is unprofessional.
FALSE: *If you start a business it may be interesting to start it at home. That way you do not have to rent a place and can keep your costs down. However, it depends on what you plan to produce. Some products can only be produced in appropriate locations.*

# Homework

Define how you plan to market your products, i.e. define product, price, promotion and place using *Hand-out 22*.


Zelimkhan Mestoev/ICRC

## MODULE 4:

# INITIAL MARKET ASSESSMENT

Now that the participants have a clear understanding of the type of business they want to operate, it is time for them to collect the information they need to assess and implement their business ideas. Module 4 prepares participants to conduct an initial market assessment for that purpose.

## Session 1: Information needs and sources[14]

Starting entrepreneurs need a simple and accurate business plan before opening their business. They must know the business environment, customers, suppliers, competitors and costs. They have to set their prices, determine the quality of their products, estimate sales, and make sure the business makes a profit. All this requires information. This session discusses what information starting entrepreneurs need and where they can obtain it.

### 1.1 What type of information is needed

Starting entrepreneurs need to understand the business environment so as to establish the business plan. The information needs and sources can be easily deduced from *Diagram 2* (page 15) and the *simple business plan* presented on page 27.

The specific information starting entrepreneurs need depends on the type of business they plan to run, but every entrepreneur must know the customers, competitors and suppliers in order to run the business. They must also know whether the utilities and infrastructure needed to operate the business are available and affordable and the rules and regulations they have to comply with when operating the business.

From the discussion of the *business plan* we know that entrepreneurs need to estimate sales and determine their needs for and the cost of equipment, material, utilities, infrastructure, labour, administration and marketing.

14 The checklists and the assessment form are adapted from BDS (2008b, p. 25).

The following checklist contains a basic set of questions to help entrepreneurs prepare an initial market assessment. It does not give them specific questions to ask because these are specific to each business and have to be developed by the entrepreneurs themselves.

**Checklist for initial market research** (see *Hand-out 24*)

| | |
|---|---|
| Competitors | Who are the main competitors for your business activity?<br>*Briefly describe who they are, what they sell and the price they charge.* |
| Similar products | What similar products can currently be found on the market?<br>*Describe the characteristics of the products (price, quality, availability), their main sales points and the strategic sales locations.* |
| Customers | To what customers does the business want to sell its products?<br>*The target customers depend on the type of goods or services offered. If you plan to offer different ranges of goods or services, you may have several groups of target customers.*<br>*Describe the specific market segments and how the business will bring the products to the customers in each of these segments.* |
| Suppliers | Who are the main suppliers of the equipment and materials needed to operate the business?<br>*Describe the quality, availability and price of the equipment and materials available.* |
| Infrastructure | What utilities and infrastructure are available?<br>*Check the available utilities and infrastructure needed to operate the business and describe their qualities and prices.* |
| Rules and regulations | What rules and regulations do you have to comply with?<br>*Describe the rules and regulations that are of relevance for your business and note any costs they may imply.* |

## 1.2 What sources of information are available

Once entrepreneurs know what information they need, they have to determine where they can obtain it. The three main sources of information are:

- the customers they plan to sell their goods and services to;
- the competitors offering products to the same customers;
- the suppliers providing the equipment and material needed.

For information on utilities, infrastructure, rules and regulations, entrepreneurs can contact:

- utility and infrastructure providers (e.g. electricity provider or neighbour with a generator);
- regulatory entities (e.g. market authority, local government, ministry of health).

Finally, entrepreneurs should find out whether there are business support services. Support can be obtained from various sources (e.g. chamber of commerce, unions, associations, private training providers, or agricultural extension services).

**Information sources for your market assessment** (see *Hand-out 25*)

| | |
|---|---|
| Talk to potential customers | • to know what products they want to buy<br>• to know what they think about your competitor's goods or services |
| Study the businesses of your competitors | • to know what they think about your specific goods or services<br>• to find out the characteristics of their goods or services<br>• to know the price they charge for their product<br>• to know how they attract customers<br>• to see how you can offer better goods or services |
| Talk to suppliers, middlemen, and business friends | • to know the prices for the equipment and materials you need<br>• to know the availability of the equipment and materials you need<br>• to know what goods or services are selling best<br>• to know what they think of your business idea<br>• to know what they think about your competitor's goods or services |
| Read newspapers, manuals, catalogues, etc. | • to get information about the goods and services offered<br>• to get ideas for new products |
| Consult support services | • to find out about the available infrastructure and respective costs<br>• to find out about entities that can offer technical support<br>• to find out about rules that govern your access to the market |

All entrepreneurs have to find out where they can obtain the best answers to their questions. The following list gives an overview of what information can be obtained from what source. It serves as a guide and is by no means exhaustive. Entrepreneurs should take any information they can get.

Often the same type of information can be obtained from different sources. Entrepreneurs should use all available sources and cross-check the information they get. This will allow them to obtain better quality information and a more accurate analysis.

### 1.3 How to conduct an initial market assessment

*Hand-out 26* contains a simple form that can help entrepreneurs conduct their initial market assessment. Entrepreneurs should not feel constrained by the form. The form should be used as a support tool and not prevent entrepreneurs from investigating other subjects and questions. It is intended to get entrepreneurs going, to help them analyse competitors and their products, customers and market segments, and suppliers of the materials and equipment needed.

Chances are entrepreneurs will not be able to obtain all the information during their first assessment effort. They should not be discouraged by this. They should just go out again and collect the missing information.

Entrepreneurs should continue assessing their business environment even after they have established their business. The business environment and markets are evolving all the time and careful observation is needed to stay informed and remain competitive.

## Session 2: Increasing the chances of obtaining good information

To be able to draw up an accurate business plan, entrepreneurs need good-quality information. This session presents a few recommendations that can help increase the chances of obtaining good-quality information from a market assessment (see *Hand-out 27*).

**Prepare your interviews**

You should prepare your questions and the order in which you plan to ask them. Ideally, the questions will lead to a natural discussion with the interviewee. A well-prepared interview allows your interviewees to speak freely and puts them at ease. You should keep interviews as short as possible but set aside as much time for them as necessary.

To check whether your questions are comprehensible and the interviews lead to a natural discussion, you can test them on friends or family members before using them on your interviewees.

**Use open-ended non-leading questions**

Avoid questions that can be answered by a simple "yes" or "no". If you want to get detailed information, let the interviewees talk about subjects of interest to them. Be a good listener and show an interest in what the interviewees are telling you. Avoid questions that simply invite them to confirm what they have just stated. You do not want the interviewees to confirm your opinion; you want to learn their opinion.

**Address your interviewees in an appropriate manner**

What is appropriate depends on several things, such as local customs, your relationship with the interviewee (e.g. someone you know or a stranger) and the social status of the interviewee. It is important to adapt your interview style to the interviewee. You must always be polite and friendly.

**Adapt your interview to the interviewee**

You will have no difficulty adapting the interview to people you know. You will know how they react in certain situations and can anticipate their behaviour by the way in which they address the subjects you want to discuss.

You will not have this advantage with people you do not know. In some situations, you may be able to observe the person before you start the interview. For example, before interviewing a competitor you can observe how the competitor treats the customers. Those observations may indicate whether the competitor is calm, quiet, patient, talkative, grumpy, etc. Depending on how you assess the competitor's behaviour, you can then adapt the way in which you conduct the interview. If the competitor is very busy, it may be better to come back some other time or else you may have to limit the interview to a few questions.

Be aware of who you are interviewing. You can ask your competitors whether their clients are happy with their goods or services, but you should be aware that the competitors' customers are a much better source of reliable information on this subject.

**Cross-check your information**

If you want reliable information, you will have to interview several people on the same subjects. This will allow you to compare the answers and increases the chances that you will get an accurate picture of the "real" situation. The potential customers interviewed are likely to have different preferences and different opinions on goods and services. You want to obtain a picture of the typical customer. You will therefore have to interview several people belonging to the group of customers you want to target.

Different competitors are likely to give different answers. Some may not want to provide correct information; others may not know the answers to the questions. Entrepreneurs should bear in mind what they learned from previous interviews when conducting an interview. Whenever a discrepancy arises, they should ask for clarification without mentioning the source of the contradictory information.

Cross-check information during an interview. If you ask complex questions, you should reformulate the interviewee's answer and ask whether you understood correctly (e.g. "So you're saying that…").

**Be aware of the interview environment**

Make sure you conduct the interviews in an environment in which the interviewees feel free to talk. If you interview customers in front of other people, they may feel shy about saying things. Look for a place that is suitable for a private discussion. If you interview a businessperson (competitor or supplier), make sure the person has the time to talk to you and that you are not obstructing the person's business. Do not ask a businessperson business-related questions in the presence of other people.

**Be alert, flexible and spontaneous**

Do not feel constrained by the questions you have prepared. Sometimes interviews can take interesting turns and reveal details you may not have thought of. Do not cut off an interviewee who is providing interesting information because it is not on the list of questions.

If you do not obtain the information by asking for it directly, ask from another angle. For example, if your competitors cannot tell you how high their sales are, ask how many customers they serve per day, whether this is representative of the whole year, and so on.

Be alert to the possibility that the discussion may drift off topic and try to bring the interviewee back to the topic of interest. This will require some tact, however, so as not to give the impression that you do not care about what the interviewee is telling you.

**Observe**

Questions are not the only way to obtain information. Observation can take an entrepreneur a long way and is a very good way to verify oral information. If a competitor claims to serve 100 customers per day but you have seen none enter the shop all day, you have reason to doubt the competitor's enthusiastic statement.

# Session 3: Conducting interviews

The best way to obtain information is to ask other people. To obtain the information they need to continue running their business, entrepreneurs have to interview competitors, potential customers and suppliers. Preparing for these interviews will increase their chances of obtaining information of value.

It is important for entrepreneurs to be aware of the ways in which different interviewees may react to an interview.

## 3.1 Possible reactions

This section presents the different ways in which different types of interviewees may react. It serves as a basis for a plenary discussion. Trainers may add examples as they wish. The aim of the discussion is for the participants to think about how different interviewees may react to being interviewed.

### Competitors

Competitors contacted in their working environment are very likely to assume the interviewer is a customer and will welcome him or her in the same way they welcome all customers. Expect them to be busy with other things and do not take too much of their time.

As soon as you start to ask questions like "How many customers do you get every day?", "How much do you sell per week?", or "Where do you buy your materials?", competitors will realize that you are not a customer and are likely to wonder what your agenda is. They are likely to ask why you are asking these questions.

Be honest and explain that you intend to start a similar business yourself.

Competitors may react in different ways. They may be **cooperative** and give you some basic information if you show that you are honest and cooperative, but they are unlikely to provide essential specific business information. Once the discussion is over, thank them for their time and leave.

Competitors may be very **talkative** and give you some vague information, but constantly deviate from the subject of interest by talking about things like family, the weather and minor problems. Remain polite and try to focus on the topics of interest. If you get no interesting information, thank them for their time and leave.

Competitors may also be **uncooperative** and tell you, for example, that they have no time for such questions as they have a business to run. Such competitors are likely to end the discussion quickly. Remain polite, thank them for their time, and leave.

In all three cases, entrepreneurs can still learn something. They can observe how competitors treat their customers (e.g. when they entered the store, other customers that were there before them), what the business looks like, what they sell, etc. These observations can be valuable, too.

Do not expect a competitor to reveal essential information or trade secrets!

**Customers**
The most likely place to find potential customers to interview is where the customers typically buy similar products (e.g. shops, market places). Many customers are likely to be in a hurry and on their way to something else. Entrepreneurs should anticipate that they will probably only be able to ask a few simple questions.

Customers are likely to be surprised to be addressed and will not understand immediately why they are being queried. Prepare to explain your intentions briefly and simply.

Customers may react in different ways. They may be **cooperative and take the time** to answer the questions. They may counter with questions of their own: “Why do you want to know this?”, “Do you know a better place to buy these products?”, or “Did you have any bad experiences with this shop?”

Listen, answer the questions, and try to create a good discussion. In the end, thank the customers for their time.

Customers may be **in a hurry** but still willing to answer a few brief questions. In that case, limit questions to the most necessary ones and keep the discussion as short as possible, then thank the customers for their time and let them go.

Customers may be **uncooperative and/or in a hurry**. In that case, do not start asking questions. Thank the customers politely and let them go.

**Suppliers**

Suppliers will generally be interested in talking to future entrepreneurs, as the latter are potential customers for them. Entrepreneurs can therefore expect them to be fairly cooperative. As for the other groups, entrepreneurs need to be aware that the suppliers may be busy.

Suppliers may react in different ways depending on the time they have at hand. If they do not have any time, ask them whether you should come back at a better time.

Suppliers are likely to give information on their products and services, but do not expect them to provide details on their customers. Suppliers may answer general questions ("How many other entrepreneurs do you sell to?" and "Where are these entrepreneurs located?"). However, suppliers are unlikely to answer specific questions on individual customers.

Although suppliers are a very interesting source of information, you should not keep them from attending to their business for too long.

## 3.2 Mock interviews

To prepare for the interviews they will conduct, the participants are now asked to conduct some mock interviews. They are grouped in pairs and have to interview each other, taking different roles. When doing this, they should keep in mind the different aspects discussed during the previous plenary discussion. Each of them should once play the role of the interviewer (entrepreneur) and once the role of the interviewee (i.e. competitor, customer, supplier). Participants should conduct the interviews as realistically as possible.

Mock interviews allow the participants to test their interview skills. They are likely to choose unsuccessful approaches and make mistakes. After each interview they should quickly discuss it. They should note on a piece of paper the questions that worked particularly well, the questions that did not work at all, and any particular situations of interest that arose.

This exercise gives them the possibility to learn from their mistakes and find better ways of approaching interviewees once they go out to assess the market.

## Homework

Conduct an initial market assessment (*Hand-outs 24, 25, 26, 27*).

Revise and update your SWOT analysis if required (*Hand-out 20*).


Boubacar Badji/ICRC

## MODULE 5:

# ESTIMATING INCOME, COST AND PROFIT

Once entrepreneurs have defined their business idea, they must assess its financial viability, i.e. whether it is likely to generate a profit. This module explains how to determine financial viability; participants learn how to estimate their potential income, costs and profit.[15]

# Session 1: Estimating income

## 1.1 What is income?

Income is the amount of money a business generates by selling its products. It depends on the price of the products and the number of products sold.

- Income = Price x Quantity

To estimate income, entrepreneurs need to define a price and estimate the quantity they are going to sell during a certain period. Because starting entrepreneurs have no experience selling their products, estimating their sales is a challenge.

It is best to estimate monthly income, because in many businesses sales show significant seasonal variations. Moreover, monthly estimates allow starting entrepreneurs to discover any financial problems quicker than bi-annual or yearly estimates, by comparing effective income to their estimates on a monthly basis.

## 1.2 How to estimate income

There are various ways to estimate future income in the absence of any past experience. Possibilities are:

- asking entrepreneurs who run similar businesses;
- observing the number of customers other businesses have and asking about their purchases;
- assuming it is possible to sell the entire output;
- asking suppliers of material how much raw material they typically sell to similar businesses;
- asking entities like the tax authorities, chamber of commerce or microfinance institutions.

15 This module is based on IFRC (2001) and BDS (2008c).

The most obvious thing to do is to observe competitors who sell similar products and ask them how much they sell during a certain period and what prices they charge. Starting entrepreneurs can then ask themselves if they are likely to sell more or less and adapt their estimates accordingly.

When estimating income, it is important to be realistic. If you exaggerate your potential income, you may end up with a large loss because you bought too many inputs to produce products you then cannot sell. To be on the safe side, a starting entrepreneur should estimate conservatively. Remember to remain a **moderate** risk taker!

Count only the days you will actually operate the business when estimating income. The number of days an entrepreneur works can vary from one business to another, and most people do not work every day of the year. In trade, it is common to have 25 working days per month for 11 months per year. These numbers take account of unforeseen events, holidays, sickness, etc.

Remember that there is a connection between the price of a product and the demand for that product. As mentioned earlier, the sales price influences the profit margin and the volume of sales. Consequently, the level at which the sales price for a product is set has a considerable impact on the profit generated.

- Profit generated = Volume of sales x Profit margin

Generally, it can be said that the higher the sales price, the lower the volume of sales and vice versa.

Entrepreneurs have to decide at what price they want to sell their goods or services. If the price is too low, they will not cover their costs and generate a loss. If the price is too high, people will not buy the goods or services.

In most cases, an entrepreneur will not be alone on the market but face competitors offering similar products. In these cases it is usually best to take the current market price to estimate income.

The following table (*Hand-out 28*) allows entrepreneurs to estimate monthly income for a single product. They can photocopy the document for other products.

| **Product:** ______________________ | | | | |
|---|---|---|---|---|
| **Month:** _______________ | | | | |
| | **Day** | **Price** | **Quantity** | **Total** |
| 1 | | | | |
| 2 | | | | |
| 3 | | | | |
| | | | | |
| 30 | | | | |
| 31 | | | | |
| Total | | | | |

Once they have estimated the monthly income for each product, entrepreneurs can think about how this amount is going to change throughout the calendar year. They should assess whether there are likely to be seasonal variations in sales volumes and prices for the different products they are planning to sell. The following table (*Hand-out 29*) can be used to estimate annual income.

| **Product:** ______________________ | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Month** | | | | | | | | | | | | **Annual** |
| | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** | **11** | **12** | |
| **Price** | | | | | | | | | | | | | |
| **Quantity** | | | | | | | | | | | | | |
| **Total** | | | | | | | | | | | | | |

## 1.3 Estimating income – a case study

The following case study uses Berthe's small business selling tea and juices to show how income can be estimated.

### Berthe's tearoom – a case study, part 1

(see *Hand-out 30*)

Berthe is planning to open a tearoom in the district she lives in. She wants to serve tea and juices to the people of her district and to passersby. Her customers will have the possibility to sit down and enjoy their beverage. They will also be able to read the local newspaper, which Berthe plans to provide for free.

Berthe also plans to sell juice over the counter. She intends to give customers not consuming their beverage in her tearoom a 10% discount on her sales price.

Berthe wants to assess the financial viability of her business idea. Having followed a business skills training course, she knows that the first step is to estimate income. She figures the best way to do this is to talk to people who run similar businesses in other districts of town and ask them how many customers they serve and at what price they sell their products.

Berthe's market assessment showed that the typical tearoom:

- Served between 30 and 50 customers per day from Monday to Thursday
  - About half of the customers consume tea – typically 2 cups
  - About half of the customers consume juice – typically 1 bottle
- Served between 80 and 100 clients per day on Fridays and Saturdays
  - Most of the customers consume tea – typically 5 cups
  - Few customers consume juice – typically 3 bottles
- Was closed on Sundays
- Sold over the counter from Monday to Friday
  - Between 50 and 100 bottles of juice per day
- Doubled sales during the months of July and August (in the tearoom and over the counter) owing to the good weather, festivities, and the holiday season
- Had stable prices throughout the year
  - Soft-drinks $10 – 15
  - Cup of tea $2 – 4

The following box shows one way to estimate Berthe's income. It is by no means the only way, as assumptions have to be made about how Berthe thinks she will perform in comparison to the tearooms she investigated during her market assessment.

## Berthe's tearoom – case study, part 1, answers

(see *Hand-out 31*)

Berthe decided that she wanted to estimate her income conservatively because she did not have much experience and wanted to reduce the risk of making a loss. She figured that she:

- could serve 30 persons per day from Monday to Thursday and that 20 of them would consume 2 cups of tea each and 10 would consume 1 bottle of juice each;
- could serve 80 persons on Friday and 80 on Saturday and that 60 of them would consume 4 cups of tea each and 20 would consume 3 bottles of juice each;
- could sell 50 bottles of juice per day over the counter from Monday to Friday;
- would double sales in July and August;
- would be open from Monday to Saturday every month except November, when she would close to take a break (to simplify her calculations, she assumed that there were exactly 4 weeks in a month);
- would charge $2 for a cup of tea and $10 for a bottle of juice.

She determined the following income:

- Monthly income from tea consumed in the tearoom:
  Normal months: *Quantity* = 20 customers x 2 cups x 4 days x 4 weeks = 640; *Price* = $2
  July and August: *Quantity* = 1,280; *Price* = $2
- Monthly income from juice consumed in the salon:
  Normal months: *Quantity* = 10 customers x 1 bottle x 4 days x 4 weeks = 160; *Price* = $10
  July and August: *Quantity* = 320; *Price:* $10
- Monthly income from juice sold over the counter:
  Normal months: *Quantity* = 50 bottles x 5 days x 4 weeks = 1,000; *Price* = $9
  July and August: *Quantity* = 2,000; *Price* = $9

She estimated a monthly income of $23,760 for July and August, $0 for November, and $11,880 for the nine remaining months. Consequently, she estimated her annual income to be $154,440.

| | Month | | | | | | | | | | | | Annual value |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | |
| **1. Tea in** | | | | | | | | | | | | | |
| **Price** | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | |
| **Quantity** | 640 | 640 | 640 | 640 | 640 | 640 | 1,280 | 1,280 | 640 | 640 | 0 | 640 | |
| **Total** | 1,280 | 1,280 | 1,280 | 1,280 | 1,280 | 1,280 | 2,560 | 2,560 | 1,280 | 1,280 | 0 | 1,280 | 16,640 |
| **2. Juice in** | | | | | | | | | | | | | |
| **Price** | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | |
| **Quantity** | 160 | 160 | 160 | 160 | 160 | 160 | 320 | 320 | 160 | 160 | 0 | 160 | |
| **Total** | 1,600 | 1,600 | 1,600 | 1,600 | 1,600 | 1,600 | 3,200 | 3,200 | 1,600 | 1,600 | 0 | 1,600 | 20,800 |
| **3. Juice out** | | | | | | | | | | | | | |
| **Price** | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | |
| **Quantity** | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 2,000 | 2,000 | 1,000 | 1,000 | 0 | 1,000 | |
| **Total** | 9,000 | 9,000 | 9,000 | 9,000 | 9,000 | 9,000 | 18,000 | 18,000 | 9,000 | 9,000 | 0 | 9,000 | 117,000 |
| **Total** | 11,880 | 11,880 | 11,880 | 11,880 | 11,880 | 11,880 | 23,760 | 23,760 | 11,880 | 11,880 | 0 | 11,880 | 154,440 |

# Session 2: Calculating costs

## 2.1 What are costs?

Every business activity involves costs. The cost of a business is the value of all the resources consumed to generate the income. Many starting entrepreneurs do not know all their costs and waste scarce resources.

Successful entrepreneurs are cost-conscious. They have to calculate the total cost of producing and selling their products. This will help them to:

- set prices;
- control and reduce costs;
- take strategic decisions and plan;
- establish their business plan.

The first step is to identify and systematize the costs of running the business, differentiating between direct and indirect costs.

**Direct and indirect costs**

*Direct costs* are costs that are directly related to a specific product sold by the business. Examples are the cost of the material used to make the product or the cost of the packaging material required to prepare it for transportation. If the business changes the number of products, these costs react directly: if it increases production, the direct costs increase; if it decreases production; the direct costs decrease.

*Indirect costs* are not directly related to a specific product; they are a consequence of the business's existence. Examples are the rent for premises, the cost of electricity, the cost of administration, and the interest on borrowed capital. All these costs occur independently of the number of products produced. They do not change when output changes.

Because indirect costs are less obvious than direct costs, entrepreneurs often forget some or all of them when calculating the financial viability of a business idea, and therefore overestimate profits. They may even come to the conclusion that the business is making profit when in fact it is generating a loss.

Entrepreneurs must identify and systematize all costs.

**Depreciation**

Entrepreneurs have to be aware of the fact that the equipment they purchase to run the business will deteriorate and have to be replaced at some point. When the time comes, they need to have the necessary funds, or they will be unable to maintain the business.

The continuous value loss of equipment over time is called depreciation. A simple way of calculating depreciation is to divide the cost of buying the equipment by the number of years it is expected to last – the result is the yearly depreciation.

$$\frac{\text{Money spent purchasing equipment}}{\text{Number of years}} = \text{yearly depreciation}$$

The concept of depreciation is generally only applied to equipment that is expensive and has an economic life-time of more than a year, such as refrigerators, bicycles, motorcycles, heaters and ovens. Examples of equipment to which the concept is not applied include cheap hand tools like a hammer, a stapler and lamps.

Entrepreneurs should plan for depreciation and set money aside to replace equipment that has broken down and can no longer be repaired (at the end of its economic life-time). They should put the equivalent of the annual depreciation of all equipment in a savings account or in a pot that is used to save money until they have saved an amount equivalent to the value of the equipment. If they save that amount before the equipment needs replacement, they can stop putting money aside.

Although the participants will receive some or all of their equipment from the ICRC, they must plan for its depreciation. If they don't, they will not be able to replace old equipment when it reaches the end of its economic life-time and they will be no longer able to run their business.

In the case of Berthe's tearoom, depreciation can be illustrated as follows: Berthe needs to buy a refrigerator to be able to sell cold juices to her customers. This business investment costs her $10,000. As Berthe knows that the refrigerator has a limited life-time and that she will have to replace it someday, she decides to set part of her annual income aside for that purpose. As she expects the refrigerator to last for 5 years, she decides to set aside $2,000.

**Total cost**

When entrepreneurs analyse the financial viability of their business they need to account for all the costs of operating the business. This means they have to add up direct costs, indirect costs and depreciation.

- Total cost = direct costs + indirect costs + depreciation

By comparing total costs to estimated income they can see whether the business is generating a profit.

## 2.2 How to calculate costs

Start by listing and categorizing all the costs of operating the business. Then collect the information needed to quantify the costs identified. This means:

- asking suppliers for the prices of the materials needed;
- asking suppliers for the prices and typical economic life-time of the equipment needed;
- asking other entrepreneurs using the same equipment for its typical economic life-time.

Again, it is best to consult different sources of information in order to be able to compare prices and cross-check information.

*Hand-out 32* can be used to calculate a business's monthly direct costs. Note that if production varies from month to month, the direct costs have to be calculated for each "type" of month. *Hand-out 33* can be used to calculate indirect costs and depreciation.

Starting businesses are vulnerable and often require some time to get running and related costs fully under control. In order to avoid unpleasant surprises at the end of the business year, starting entrepreneurs should estimate their income and calculate their costs on a monthly basis, as suggested in the hand-outs. They can thus monitor the development of their businesses at shorter intervals and react as soon as the businesses deviate from the plan.

## 2.3 Calculating Costs – the case study continued

The case study of Berthe's small business is continued to provide an example for how total costs can be calculated.

**Berthe's tearoom – case study, part 2** (see *Hand-out 34*)

After having estimated her monthly and annual income, Berthe set out to determine her business's total monthly and annual costs. She knew that she had to consider her direct, indirect and depreciations costs.

She had to calculate the costs related to:

- the tea;
- the juices;
- the five newspapers that she would buy every day (6 days per week) for her customers;
- the cleaning lady that would clean the tearoom once a week;
- electricity;
- the operating licence.

Berthe consulted her suppliers to obtain the prices of the material and equipment she would need and she asked one specialist to tell her how long her equipment would last. This is the information she received:

- Tea: Purchase price = $4 for every 40 cups
- Juice: Purchase price = $5 for each bottle
- Rent $4,000 per month
- Refrigerator: Purchase price = $10,000
- Life-time: 5 years
- Newspapers: $4 each
- Cleaning: $50 per week
- Electricity: $200 per month
- Licence: $500 per year
- Refrigerator maintenance: $750 twice a year

The following box shows how Berthe's total costs are calculated. Note that the direct costs are based on the assumptions she made when she estimated her income. Also note that it is assumed that both rent and electricity have to be paid for 12 months as it is unlikely that the landlord cares that Berthe is not open in November and it is likely that Berthe will keep the refrigerator running.

## Berthe's tearoom – case study, part 2, answers

(see *Hand-out 35*)

Based on her calculations, Berthe came up with the costs below.

### *Direct costs*

Berthe knew that she would have to calculate her "normal" months and the peak months of July and August separately as she estimated that the respective sales would differ significantly.

| **Month: Normal** | | | |
|---|---|---|---|
| **Item** | **Quantity** | **Cost** | **Total** |
| Tea | 640 cups (16 x 40 cups) | $4 per 40 cups | 64 |
| Juice | 1,160 bottles | $5 | 5,800 |
| **Total** | | | 5,864 |

| **Month: Peak (July and August)** | | | |
|---|---|---|---|
| **Item** | **Quantity** | **Cost** | **Total** |
| Tea | 1,280 cups (32 x 40 cups) | $4 per 40 cups | $128 |
| Juice | 2,320 bottles | $5 | $11,600 |
| **Total** | | | $11,728 |

Her total direct costs amount to (9 months x $5,864) + (2 months x $11,728) = $76,232.

### *Indirect costs*

| **Item** | **Quantity** | **Cost** | **Total** |
|---|---|---|---|
| Newspapers | 6 days x 4 weeks x 11 months x 5 papers = 1,320 papers | $4 | $5,280 |
| Cleaning | 4 weeks x 11 months = 44 weeks | $50 | $2,200 |
| Rent | 12 months | $4,000 | $48,000 |
| Electricity | 12 months | $200 | $2,400 |
| Fridge maintenance | 2 times a year | $750 | $1,500 |
| Licence | Annual | $500 | $500 |
| **Total** | | | $59,880 |

The total annual indirect costs per year amount to $59,880.

### *Depreciation*

| **Equipment** | **Purchase price** | **Life-time in years** | **Annual depreciation** |
|---|---|---|---|
| Refrigerator | $10,000 | 5 | $2,000 |
| **Total** | | | $2,000 |

Depreciation amounts to $2,000 per year.

Thus, Berthe calculates her total annual costs at $76,232 + $59,880 + $2,000 = $138,112.

# Session 3: Calculating profit

## 3.1 What is profit?

Once entrepreneurs have estimated their income and calculated their respective total costs, they can calculate profit and the profit margins of their products. Remember that profit is calculated by subtracting total costs from income.

- Total income – direct costs – indirect costs – depreciation = profit

A business's income must exceed its total costs to generate a profit. A profit-maximizing business must closely monitor its costs and try to keep them as low as possible. Lowering cost is the most straightforward way to increase profit.

You can lower costs by, for example:

- turning off lights and water when you do not need them;
- handling your equipment with care and maintaining and cleaning it to prevent breakdown;
- trying to work as fast as possible without compromising product quality;
- optimizing your workplace layout (e.g. store your inputs closer to where you produce, see that everybody has enough space to work so that they are efficient);
- looking out for suppliers with the most competitive prices for the materials you need;
- optimizing the size of your orders for material and trying to get rebates for large orders;
- not buying too much material ahead of time and/or reducing spoilage of materials and products;
- checking whether it is cheaper to rent equipment instead of owning it;
- if you employ people that do not have work all the time, hiring them by the hour.

Note that there is often a trade-off between the price and the quality of materials and equipment. Always make sure that the materials and equipment you acquire are of sufficient quality to produce the required quality of products.

## 3.2 Calculating profit –the case study continued

The case study of Berthe's small business is continued to provide an example of how profit can be estimated.

**Berthe's tearoom – a case study, part 3** (see *Hand-out 36*)

After having estimated her monthly and annual income and her total costs, Berthe was now ready to determine whether her business would generate a profit.

Because Berthe knew that a starting business is vulnerable and requires close monitoring, she decided to calculate her annual and her monthly profits. This way she would be able to monitor on a monthly basis whether her business was performing according to plan. To do this, Berthe decided to spread the indirect costs and depreciation evenly across the 11 months per year her business would be open.

She prepared the following form to determine her monthly and annual profit:

| | Month | | | | | | | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | |
| Income | | | | | | | | | | | | | |
| Direct costs | | | | | | | | | | | | | |
| Indirect costs | | | | | | | | | | | | | |
| Depreciation | | | | | | | | | | | | | |
| **Profit** | | | | | | | | | | | | | |

The following box shows one way of calculating Berthe's monthly and annual profit. Berthe decided to spread the indirect costs and the depreciation evenly over the eleven months she is open. She could also have spread them according to the estimated sales in each month or she could have spread them over 12 months and accepted a loss in November, since she generates no income during that month. The important thing is to take a conscious decision and to be aware of all costs.

## Berthe's tearoom – case study, part 3, answers

(see *Hand-out 37*)

Berthe's profit:

| | Month | | | | | | | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | |
| Income | 11,880 | 11,880 | 11,880 | 11,880 | 11,880 | 11,880 | 23,760 | 23,760 | 11,880 | 11,880 | 0 | 11,880 | 154,440 |
| Direct costs | 5,864 | 5,864 | 5,864 | 5,864 | 5,864 | 5,864 | 11,728 | 11,728 | 5,864 | 5,864 | 0 | 5,864 | 76,232 |
| Indirect costs | 5,444 | 5,444 | 5,444 | 5,444 | 5,444 | 5,444 | 5,444 | 5,444 | 5,444 | 5,444 | 0 | 5,444 | 59,884 |
| Depreciation | 182 | 182 | 182 | 182 | 182 | 182 | 182 | 182 | 182 | 182 | 0 | 182 | 2002 |
| **Profit** | 390 | 390 | 390 | 390 | 390 | 390 | 6406 | 6406 | 390 | 390 | 0 | 390 | 16,322 |

Note that the totals vary slightly because the numbers in the table were rounded up.

If Berthe's estimate proves to be accurate, she would generate a profit of $430 in a normal month and a profit of $6,406 in the peak months of July and August.

Her annual profit would amount to $16,682.

Berthe could increase her profit by, for example:

- raising her prices slightly (she set them rather low to be on the safe side);
- cleaning the tearoom herself and saving the cleaning lady's salary or only hiring the cleaning lady in July and August, when she is busiest;
- checking whether she can reduce the amount of peanuts she gives her clients for free;
- trying to negotiate rebates for large orders of soft drinks and beer with her supplier.

As a starting entrepreneur, Berthe may rethink her decision to employ a cleaning lady. If she has the time, this would be the easiest way to increase her income and reduce her costs and risk.

# Session 4: Pricing

There are different ways to set prices. However, three general points have to be considered:

- the price has to cover the total cost of a product;
- the price should not be higher than what customers are willing to pay;
- competitors' prices need to be taken into account.

In the case study, Berthe set the same prices as her lowest-priced competitors. This is a safe strategy because she knows that they are able to sell their product at these prices – customers are willing to buy. Her cost analysis showed, moreover, that with her estimated sales she would be able to cover all costs.

An entrepreneur can also set a price by determining the total cost of a product and adding an adequate profit margin. The profit margin is the positive difference between sales price and the total cost of a product.

- Profit margin: sales price – product cost

The sales price must be high enough to cover the direct costs, the indirect costs and depreciation. This means calculating total costs per unit. This often requires assumptions and is therefore best explained with an example.

### Berthe's tearoom – case study, part 4

(see *Hand-out 39*)

Berthe decided that she wanted to know how much profit she was making from each beverage. She decided to determine the profit margins of her two products in order to better understand her business.

She collected the following information:

- Estimated yearly tea sales:
  9 months x 640 cups + 2 months x 1,280 cups = 8,320 cups of tea
- Direct costs per cup of tea = $0.10
- Estimated yearly juice sales:
  9 months x 160 bottles + 2 months x 320 bottles
  9 months x 1,000 bottles + 2 months x 2,000 bottles = 15,080 bottles of juice
- Direct costs per beer bottle = $5
- Annual indirect costs = $59,880
- Annual depreciation = $2,000

Berthe decided that she would spread the indirect costs evenly over the beverages sold:

- Beverages sold: (8,320 cups of tea + 15,080 juice bottles) = 23,400 beverages
- Indirect cost per beverage: $59,880 / 23,400 beverages = $2.56 per beverage

Berthe decided that she would spread the depreciation evenly over the bottles of juice sold, as the tea did not need refrigeration:

- Annual depreciation per bottle: $2,000 / 15,080 bottles = $0.13 per bottle

Berthe calculated the following total costs per beverage:

- Total cost tea/cup: $0.10 direct costs + $2.56 indirect costs = $2.66
- Total cost juice/bottle:
  $5 direct costs + $2.56 indirect costs + $0.13 depreciation = $7.69

This meant her profit margins were:

- Tea/cup: $2 sales price – $2.66 total costs = $**–0.66** per cup
  This meant that the price Berthe had set for a cup of tea did not cover the total costs as she had attributed them. Although the price was high enough to cover the direct costs of $0.10, it was not high enough to cover the indirect costs of $2.56.
  It is important to note that the tea sales still contributed to the financial success of Berthe's tearoom, because they helped cover some of the indirect costs.
- Juice/bottle consumed in the tearoom:
  $10 sales price – $7.69 total costs = $2.31 per bottle
- Juice/bottle sold over the counter:
  $9 sales price – $7.69 total costs = $1.31 per bottle

This meant that each bottle of juice sold in the tearoom or over the counter covered its direct costs ($5) plus the attributed share of indirect costs and depreciation ($2.69).

In general, the sales price for a product should cover more than its direct costs, otherwise the business loses money with each unit sold. Entrepreneurs therefore have to stop production if the sales price of a product does not cover that product's direct costs.

The sales price should also cover the indirect costs and depreciation. As soon as the sales price covers more than the direct costs of the product, selling the product helps to cover the indirect costs and depreciation, i.e. each product sold brings in some money to cover the indirect costs and depreciation. Increasing the sales volume of such products increases their contribution to covering indirect costs and depreciation. If sales can be increased sufficiently, the product might actually have a positive profit margin.

Increasing the price of a product that is not covering its total cost is also a possibility. However, entrepreneurs should not forget that not only does the sales price directly affect the product's profit margin, it also influences demand for that product, and therefore the volume of sales. In general, it can be said that the higher the sales price, the lower the volume of sales and vice versa. Consequently, the level at which the sales price for a product is set has a considerable impact on the profit generated.

Typically, small businesses produce products that are already available on the market and there are limited possibilities for product diversification. This means that in many cases the prevailing market price for a product or service provides the upper limit for setting the sales price. The lower limit is, of course, given by the cost of producing the product or service.

Again, when setting a price, entrepreneurs have to consider the total cost of the product, the customers' willingness to pay, and competitors' prices.

Note: *These profit-margin calculations may be too complicated for some participants. If this is the case, trainers can simplify the module by focusing on simple income, cost and profit calculations. This will allow participants to see if their projects are financially viable. Participants can perform the calculation with different prices to see how this changes their profit. This is more* *tedious but it highlights the necessary information. The important thing is that they do not lose money, i.e. they should not sell products at prices that are lower than the direct cost.*

*The advantage of the calculations in this section is that they provide more detailed information on the extent to which different products contribute to the success of a business. However, the calculations are not crucial and can be left out if deemed too complicated.*

## Homework

Estimate your income (*Hand-outs 28, 29*).

Estimate your cost (*Hand-outs 32, 33*).

Estimate your profit (*Hand-out 38*).

Calculate the profit margins of your products (*Hand-out 40*) (optional).

Hussein Al Seadi/ICRC

## MODULE 6:

# FINANCING A BUSINESS

Once entrepreneurs have assessed the financial viability of their business idea, they must determine how much capital they need to procure the equipment and materials needed to operate the business, i.e. they need to determine their capital and cash needs. One way to do this is to conduct an income and expenditure analysis. This module concentrates on these financing questions. It discusses investment and working capital needs and shows how they influence cash flow.

## Session 1: Capital needs

Entrepreneurs starting a business face plenty of expenditures before they can generate any income. To be able to start the business, they need capital to cover initial expenses. They may have to procure equipment and materials, rent business facilities, pay salaries, and so forth. They must bridge the gap between these initial expenses and the moment the business starts to generate sufficient income to cover its operational costs.[16]

### 1.1 Capital investment

One-time costs are things entrepreneurs spend money on to get the business going but are usually not recurring. Such costs include:

- licences and permits
- production equipment
- decorating costs
- base inventory
- training.

These expenditures can be seen as investments on which entrepreneurs expect financial returns in the near future. The extent of these expenditures depends on the type of activity. A contract worker may only need a few tools to start a business, but a carpenter needs a workshop, electricity, equipment, wood and other things to start production.

16 See also CISP (2011) and IFRC (2001).

Starting entrepreneurs have to be cautious before making large investments because there is always the risk that the business will not work out. A good way to limit the initial investment is to rent part of the equipment instead of buying it and to keep the initial inventory only just as high as needed.

The amount of capital needed to cover these investments is easy to calculate: just identify them and add up the costs. Starting entrepreneurs should be very cost-conscious. They should ask themselves which of these investments are really necessary and how their costs can be kept to a minimum while maintaining the required standard of quality.

### 1.2 Working capital

Every business generates costs before it generates profit. The capital required to cover initial recurring operational costs is called working capital. It is the capital needed to keep the business running until it generates sufficient income to cover all the costs of running it. Such costs include:

- materials and replacement materials
- maintenance costs
- the salaries of any employees
- rent for business premises
- electricity bills
- advertising and promotion costs.

This is what people mean when they say, "It takes money to make money." Having enough capital to start a business is critical for long-term success. The best business idea cannot work if there are not sufficient funds to bring it to the point where the income it generates starts covering costs.

The question for entrepreneurs is, "How much money do I need to start my business?" When determining the amount required, they must also include personal needs. After all, the entire family needs to be able to make it to the point where the business starts to provide for them.

Determining the amount of capital needed to run a business requires several calculations and estimates. It depends on recurring expenditures such as payments for material, rent for a workshop and the entrepreneur's salary. It also depends on how the business develops in terms of income: sales may start slowly and income may be insufficient to cover all of those costs. However, as the business becomes better known and sales pick up, it should eventually reach the point where income is sufficient to cover all costs and the business starts generating profit. Entrepreneurs have to estimate their monthly recurring expenses and monthly sales to estimate working capital needs.

Without sufficient working capital, a business risks running out of cash. If this happens, it can no longer pay the costs of running the business and it has to close down.

Again, entrepreneurs should try to keep recurring costs as low as possible when starting a business. For example, they should refrain from employing unnecessary staff unless they are sure the staff are needed and they should keep material purchases as low as possible but sufficient to cover needs.

# Session 2: Estimating capital requirements

A good way to determine the cash needs of a starting business is to conduct an income and expenditure analysis. In such an analysis, entrepreneurs estimate their monthly income, the costs of initial investments, and recurring operational expenses. Put into a simple table, this information can be used to determine the cash flow of the business. The cash flow is simply the money flowing into and out of a business. As money is needed to pay recurring expenses, it is important to know if a business is generating sufficient money to cover expenditures. This is best explained using a simple example.[17]

The following box shows an income and expenditure analysis for Lara's dumpling business. The capital investment needs are easy to calculate and need no further explanation. To determine her working capital needs, Lara calculated her monthly free cash flow, i.e. the cash that remained after paying the costs of running the business.

Lara's calculations showed that her business would generate a negative cash flow during the first five months. In other words, during the first five months, her business is not generating enough money to cover all the expenses incurred in running it – she will not be able to pay all the materials, utilities and transport required.

To determine her working capital needs, Lara calculated the cumulative free cash flow. In the first month the business had many initial expenses and more money flowed out of it than into it. The business therefore generated a negative cash flow (– $3,675). In the second month, the business faced fewer expenses and more money was flowing into it than out of it; the business generated $625 of available money (free cash flow). Going through the different months, Lara saw that the fourth month incurred the largest negative cash flow (– $4,250). She therefore knew that if she could start her business with $4,250 in cash, she would be able to pay for all the

17 Adapted from IFRC (2001, p. 29) and ICRC (2009, p. 128).

expenses of running it until it started generating enough cash to do so.

The second table shows that a working capital of $4,250 is indeed sufficient to bridge the gap. Lara would be well advised, however, to plan a little extra for unforeseen events.

Moreover, she should consider her own personal expenses. She will have to eat and drink, maybe pay rent, maybe require money for transport, etc. In other words, she needs money to live during the time her business is not generating enough money to provide her with an income. She should therefore include a basic salary in her calculations and determine her working capital needs on that basis.

Entrepreneurs should never forget to include their personal financial needs in the assessment of capital requirements. The best way of doing this is to include a monthly salary that covers their personal expenses.

**Lara's dumpling business** (see *Hand-out 41*)

Lara heard about the possibility of obtaining a grant from the ICRC to start a small business. She developed a business idea and applied for a grant. Having followed a business skills training course once, she knew that she had to estimate her capital requirements. She came up with the estimate below, which she communicated to the ICRC.

### Capital investment

| | |
|---|---|
| • Purchase of a refrigerator | $11,000 |
| • Purchase of a mixer | $3,000 |
| • Purchase of a mincer | $2,000 |
| Total capital investment needs | $16,000 |

### Working capital

- She estimated her monthly income over the next 12 months. She knew that it would take her some time to convince retailers and supermarkets to start selling her dumplings, and therefore estimated her sales for the first four months conservatively.
- She estimated that after four months she would be able to sell all she could produce.

| | Month | | | | | | | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | |
| **Sales revenue** | | | | | | | | | | | | | |
| | 2,000 | 2,000 | 3,000 | 4,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 75,000 |
| **Operational expenses** | | | | | | | | | | | | | |
| Flour | 25 | 25 | 50 | 100 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 1,800 |
| Oil | 100 | 100 | 200 | 300 | 600 | 600 | 600 | 600 | 600 | 600 | 600 | 600 | 5,500 |
| Minced meat | 150 | 150 | 300 | 550 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 9,150 |
| Salt and spices | 100 | 100 | 150 | 250 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 4,600 |
| Packaging | 1,000 | | | 1,000 | | | 1,000 | | | 1,000 | | | 4,000 |
| Cleaning materials | 2,500 | | | 2,500 | | | 2,500 | | | 2,500 | | | 10,000 |
| Transportation costs | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 12,000 |
| Utilities | 800 | | 800 | | 800 | | 800 | | 800 | | 800 | | 4,800 |
| **Total** | 5,675 | 1,375 | 2,500 | 5,700 | 4,100 | 3,300 | 7,600 | 3,300 | 4,100 | 6,800 | 4,100 | 3,300 | 49,600 |
| **Free cash flow** | | | | | | | | | | | | | |
| | -3,675 | 625 | 500 | -1,700 | 3,900 | 4,700 | 400 | 4,700 | 3,900 | 1,200 | 3,900 | 4,700 | 23,150 |
| **Cumulat. free cash flow** | | | | | | | | | | | | | |
| | -3,675 | -3,050 | -2,550 | -4,250 | -350 | 4,350 | 4,750 | 9,450 | 13,350 | 14,550 | 18,450 | 23,150 | |

Lara saw that for the first five months her business would not generate sufficient cash to support itself. She saw that she needed at least $4,250 to bridge the gap.

| | Month | | | | | | | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | |
| **Sales revenue** | | | | | | | | | | | | | |
| | 2,000 | 2,000 | 3,000 | 4,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 75,000 |
| **Operational expenses** | | | | | | | | | | | | | |
| **Total** | 5,675 | 1,375 | 2,500 | 5,700 | 4,100 | 3,300 | 7,600 | 3,300 | 4,100 | 6,800 | 4,100 | 3,300 | 49,600 |
| **Working capital** | | | | | | | | | | | | | |
| **Total** | 4,250 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4,250 |
| **Free cash flow** | | | | | | | | | | | | | |
| | 575 | 625 | 500 | -1,700 | 3,900 | 4,700 | 400 | 4,700 | 3,900 | 1,200 | 3,900 | 4,700 | 27,400 |
| **Cumulat. free cash flow** | | | | | | | | | | | | | |
| | 575 | 1,200 | 1,700 | 0 | 3,900 | 8,600 | 9,000 | 13,700 | 17,600 | 18,800 | 22,700 | 27,400 | |

Lara knew she would have to wait four months before she could take any money out of the business for her personal use, yet she had calculated that her personal savings were sufficient to cover her personal expenses during the next seven months.

# Session 3: Sources of capital

Once entrepreneurs have determined their capital needs, they need to find out where they can obtain the capital to start the business. Possible sources are an ICRC grant, their own funds, and loans.

## 3.1 ICRC grant

A grant from the ICRC is the way MEI beneficiaries cover at least part of their capital requirements. As with any programme, the beneficiaries have to take into account and follow certain rules. This is a good moment for trainers to communicate the specific rules of the MEI programme. For example, beneficiaries may have to:

- finish the business skills training course and complete all homework to qualify for the programme;
- supplement the ICRC's grant with their own funds (x amount) to prove their commitment and qualify for the programme;
- open their business within two weeks of receiving the first instalment.

The ICRC should require beneficiaries to provide an estimate of their investment and working capital needs. Calculating these needs forces them to think about their project and improves their understanding of it. To the ICRC, it shows the beneficiaries are dedicated and motivated and gives an idea of their business management skills. The course material allows beneficiaries to do the calculations.

## 3.2 Own funds

Many starting entrepreneurs have saved money for quite a while to be able to start their business. Some sell assets such as land or livestock. Using their own funds creates independence. Entrepreneurs should cultivate a culture of saving money, which will allow them to make future investments unassisted.

One way of increasing one's own funds is to team up with one or more partners who can pump money into the business.

However, this requires careful consideration, as the business needs to generate enough profit to provide a return to all those who invested in it.

Entrepreneurs investing their own funds in their business also send out a message to third parties. They show that they believe in the business and that they are ready to risk their own money to run it – they show commitment. Showing this type of commitment can prove crucial when they decide to apply for funds from a financial institution like a microcredit institute, a bank or moneylenders.

Microfinance institutions and NGOs providing grants for small businesses often demand a personal contribution of funds from the entrepreneur to supplement a loan or a grant.

### 3.3 Loans

Entrepreneurs with a convincing business idea and a good business plan illustrating its potential profitability may qualify for a loan from a financial institution. Often, however, loans are granted only if the entrepreneur has some type of collateral (e.g. is the owner of a house ).

Entrepreneurs who use loans to start their business must add the respective costs – i.e. interest payments and reimbursement of the principal – to all their calculations!

For starting entrepreneurs with limited means and no collateral, loans are usually not accessible.

Entrepreneurs who have a seasoned business and can illustrate their financial viability and profitability have a better chance of obtaining a loan. This is another reason for entrepreneurs to keep records and properly document the profitability of their business.

# Homework

Estimate your capital requirements and determine your capital sources (*Hand-out 42*). Do not forget to mention any funds of your own that you plan to invest!

Refer to your previous calculations (*Hand-outs 29, 32, 33, 36*).

Leila Sataeva/ICRC

## MODULE 7:

# KEEPING RECORDS AND MANAGING FINANCES

Records management is critical to business growth, works in favour of informed decision-making, and facilitates accountability and the burden of proof when dealing with institutions like banks and microfinance institutes, suppliers, and others. Once entrepreneurs have launched their business idea, they must manage and closely monitor the financial aspects of the business. To do this, they need a system for keeping records and some basic knowledge of how to manage finances. This module provides participants with a basic accounting system and gives some general recommendations on how to manage a business's finances.

## Session 1: Keeping records

Microenterprises, like those operated by the beneficiaries of MEI programmes, do not need complex accounting systems. This session introduces a simple cashbook and two forms for recording sales and purchases on credit.[18]

### 1.1 What is record-keeping and why is it done

Businesses buy and sell goods and services all the time – they conduct many transactions. The transactions are too numerous and complex to be remembered by entrepreneurs over a long period of time. Hence, without any records, entrepreneurs will have a hard time knowing whether they are making a profit or losing money. The process of keeping systematic and sequential records of business transactions is called accounting. An accounting system tells the entrepreneur at any point in time how much the business owns, how much other people owe the business, and how much the business owes other people.

To operate a business successfully, entrepreneurs need to know the financial situation of their business. An accounting system allows them to:

- know how much customers owe them;

18 Receipts can also help starting entrepreneurs monitor their transactions. However, because past experience with the MEI programme has shown that very few beneficiaries actually issue receipts once they start running their business, the subject is not covered in this training course. For more complex record-keeping systems, see, for example, ILO (2009c) or FAO (1994b).

- know how much they owe suppliers and other stakeholders;
- know the level of capital in the business;
- know the profit and loss status for any specific period of time;
- obtain the information needed to plan (e.g. production, inventory, sales, credit policy);
- control the costs and expenses of the business;
- identify the profitability of the business;
- monitor purchase and sales prices;
- guarantee transparency (important if the business is run by partners);
- introduce accountability (vis-à-vis employees).

A properly managed and regularly updated accounting system allows entrepreneur to manage their business smoothly. Without such a system, they risk losing money. An accounting system can also help demonstrate the financial viability of the business when trying to obtain credit.

## 1.2 Basic records[19]

The simplest way of keeping accounts is to run a simple cash-book and to record sales and purchases on credit.

### Cashbook

The cashbook is used to keep track of the daily business transactions that are conducted on a cash basis. The book records all the cash that is coming into and going out of the business, i.e. only cash transactions are registered. Credit sales and purchases on credit are not recorded in this book.

The following table presents a simple form of cashbook that includes a bank account. If entrepreneurs have the possibility to open a bank account, this is certainly to be recommended. A bank account allows them to save for unforeseen events and to put away the value of depreciation in order to be able to repair or replace equipment once it breaks down.

19 Adapted from BDS (2008c).

## Cashbook with bank account

(see *Hand-out 43*)

| Cashbook of: Red Hot Chilli Peppers Inc. | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Month: March** | | | | | | | | |
| **Date** | **No.** | **Transaction** | **Cash** | | | **Bank** | | |
| | | | Cash in | Cash out | Balance | Bank in | Bank out | Balance |
| **Amounts carried forward** | | | | | 10,500 | | | 50,000 |
| 1.3 | 1 | Sales | 200 | | 10,700 | | | 50'000 |
| 3.3 | 2 | Purchase production materials | | 5,000 | 5,700 | | | 50,000 |
| 4.3 | 3 | Purchase office material | | 300 | 5,400 | | | 50,000 |
| 4.3 | 4 | Sales | 800 | | 6,200 | | | 50,000 |
| 15.3 | 5 | Sales | 2000 | | 8,200 | | | 50,000 |
| 16.3 | 6 | Sales | 3300 | | 11,500 | | | 50,000 |
| 16.3 | 7 | Bank deposit | | 2,500 | 9,000 | 2,500 | | 52,500 |
| 18.3 | 8 | Payment electricity | | 550 | 8,450 | | | 52,500 |
| 22.3 | 9 | Sales | 750 | | 9,200 | | | 52,500 |
| 28.3 | 10 | Purchase production materials | | 4,000 | 5,200 | | | 52,500 |
| 29.3 | 11 | Sales | 600 | | 5,800 | | | 52,500 |
| 29.3 | 12 | Bank withdrawal for cash registry | 1,000 | | 6,800 | | 1,000 | 51,500 |
| (a) Total/Balance (this page) | | | 8,650 | 12,350 | -3,700 | 2,500 | 1,000 | 1,500 |
| (b) Values carried forward (from previous page) | | | 18,500 | 8,000 | 10,500 | 65,000 | 15,000 | 50,000 |
| (c) Values to carry forward (to the next page) | | | 27,150 | 20,350 | 6,800 | 67,500 | 16,000 | 51,500 |

The cashbook shows the business's cash situation at any time. It shows both the money that has entered the business (*Cash in*) and the money that has gone out of the business (*Cash out*). The balance column shows the difference between the two.

This extended version also includes a bank account. The money deposited in the bank account is entered in the column *Bank in* and the money that is withdrawn is entered in the column *Bank out*. Again, the balance column shows the difference between the two.

The last three lines are used to summarize the transactions. Line (a) indicates the sums of the columns *Cash in* and *Cash out* and their balance, and the sums of the columns *Bank in* and *Bank out* and their balance; line (b) indicates the same values as the previous page; and line (c) indicates the sums of the values from line (a) and line (b).

### Sales on credit and purchases on credit

Because the cashbook contains only transactions that were conducted in cash, we need a tool to account for sales and purchases conducted on credit. The following two forms help the entrepreneur keep track of transactions on credit.

**Sales on credit** (see *Hand-out 44*)

**Sales on credit**

Name of the customer: Kingsley Midas
Contact information: Dengi Village, Tel. : 333 66 69
Maximum credit line: $7,500

| Date | Transaction | Price | Amount paid | Outstanding amount | Signature |
|---|---|---|---|---|---|
| 24.5 | Sale 50 kg of chicken feed | 5,000 | 1,000 | 4,000 | K. Midas |
| 13.6 | Reimbursement | | 3,500 | 500 | H. Pestalozzi |
| 15.6 | Sale 25 kg of chicken feed | 2,500 | 0 | 3,000 | K. Midas |
| 01.7 | Sale equipment | 4,500 | 0 | 7,500 | K. Midas |
| 15.7 | Reimbursement | | 4,000 | 3,500 | H. Pestalozzi |
| 31.7 | Reimbursement | | 3,500 | 0 | H. Pestalozzi |

Note: One form per customer
Customers sign when they receive the credit to confirm.
The business representative signs when the credit is reimbursed to confirm.

With sales on credit there is always the risk that they will not be reimbursed. Thus, whenever possible, sales should be made in cash. Entrepreneurs should only give credit to customers they know well. They should establish a credit line for each customer they give credit to and closely monitor repayment. The "Sales on credit" form helps them do this.

The form also prevents misunderstandings by having the two parties confirm all transactions: customers receiving credit confirm their debt with a signature and the entrepreneur confirms the customers' reimbursement with a signature. This prevents disagreements.

Note that an entrepreneur should keep a separate record (i.e. form) for each customer receiving credit. This way, customers cannot be mixed up and the customer information is protected, as only the person mentioned on the form and the entrepreneur see the amounts.

Suppliers sometimes offer credit to their customers. They normally establish a maximum credit line and a fixed repayment period. Entrepreneurs should be careful not to abuse this service and make sure they reimburse their credits on time. They thereby establish a good credit record and build up a relationship of trust with suppliers. The "Purchases on credit" form can be used for this.

The form also prevents misunderstandings by having the two parties confirm all transactions. Entrepreneurs receiving the credit confirm their debt with a signature and the supplier confirms the entrepreneur's reimbursement with a signature. This prevents disagreements.

Note that entrepreneurs should keep a separate record (i.e. form) for each supplier from whom they receive credit. This way, suppliers cannot be mixed up and the entrepreneur's information is protected, as only the entrepreneur and the supplier see the amounts.

**Purchases on credit** (see *Hand-out 45*)

**Purchases on credit**

Name of supplier: Putput Chickenfeed Inc.
Contact information: Moneytown, Gold Street 12, Tel. 876 9090
Credit period: 30 days
Credit line: $50,000

| Date | Transaction | Credit amount | Amount paid | Outstanding amount | Signature |
|---|---|---|---|---|---|
| 01.5 | Purchase 500 kg chicken feed | 25,000 | 0 | 25,000 | H. Pestalozzi |
| 15.5 | Purchase 500 kg chicken feed | 25,000 | 0 | 50,000 | H. Pestalozzi |
| 29.5 | Reimbursement | | 25,000 | 25,000 | P. Putput |
| 05.6 | Reimbursement | | 15,000 | 10,000 | P. Putput |
| 07.7 | Purchase 250 kg chicken feed | 15,000 | 0 | 25,000 | H. Pestalozzi |
| 10.7 | Reimbursement | | 10,000 | 15,000 | P. Putput |

Note: One form per supplier
The business representative signs on receiving the credit to confirm.
The supplier signs when the credit is reimbursed to confirm.

Also note that as soon as a credit has been reimbursed – a payment made from a customer to the entrepreneur or from the entrepreneur to a supplier – the amount paid must also be recorded in the cashbook. Cash comes into the business when customers reimburse a credit, money goes out of the business when the entrepreneur reimburses a credit.

### 1.3 Basic record-keeping exercise

The following box contains an exercise to practice booking the various transactions discussed above. The transactions are spread over two months, so the participants have to close their cashbook sheet and carry forward the totals and balances from one month to the next.

**Record-keeping exercise** (see *Hand-outs 46, 47, 48, 49*)

On 1 June, Lance opened a bicycle repair shop. What follows are the business transactions for the months of June and July. Enter the transaction into Lance's accounting system (i.e. Cashbook, "Sales on credit" form and "Purchases on credit" form).

**June 1**
- Lance brings in $11,000 cash
- Money in the bank $35,000
- Purchase repair mat. on credit $15,000 from Ferdy K.
- Transfer from bank to cash account $20,000
- Purchase of tools $25,000 paid in cash
- Purchase commercial licence $500

**June 10**
- Cash sales of bicycle material $4,000
- Cash for repair services $3,000

**June 17**
- Sale of repair services on credit $3,500 to Tony R.

**June 15**
- Transfer cash to bank account $5,000

**June 25**
- Cash sales repair services $2,500
- Cash sales of bicycle material $6,000

**July 1**
- Sale of material on credit $1,000 to Tony R.
- Reimbursement credit $15,000 to Ferdy K.
- Sales repair services $3,300

**July 8**
- Sales of repair services $5,000
- Sales of material $7,500

**July 19**
- Transfer from cash to bank account $10,000

**July 25**
- Reimbursement credit $4,000 by Tony R.

**July 31**
- Purchase repair mat. on credit $20,000 from Ferdy K.

The answers are provided below.

## Record-keeping exercise – answers

(see *Hand-out 50*)

### Cashbook of Lance's bicycle repair shop

**Month: June**

| Date | No. | Transaction | Cash | | | Bank | | |
|---|---|---|---|---|---|---|---|---|
| | | | Cash in | Cash out | Balance | Bank in | Bank out | Balance |
| Balance carried forward | | | | | | | | |
| 01.6 | 1 | Initial cash | 11,000 | | 11,000 | | | |
| 01.6 | 2 | Initial money in bank | | | 11,000 | 35,000 | | 35,000 |
| 01.6 | 3 | Transfer bank to cash account | 20,000 | | 31,000 | | 20'000 | 15,000 |
| 01.6 | 4 | Purchase of tools | | 25,000 | 6,000 | | | 15,000 |
| 01.6 | 5 | Payment commercial licence | | 500 | 5,500 | | | 15,000 |
| 10.6 | 6 | Sales of material | 4,000 | | 9,500 | | | 15,000 |
| 10.6 | 7 | Sales repair services | 3,000 | | 12,500 | | | 15,000 |
| 15.6 | 8 | Transfer cash to bank account | | 5,000 | 7,500 | 5,000 | | 20,000 |
| 25.6 | 9 | Sales of repair services | 2,500 | | 10,000 | | | 20,000 |
| 25.6 | 10 | Sales of bicycle material | 6,000 | | 16,000 | | | 20,000 |
| Total balance (this page) | | | 46,500 | 30,500 | 16,000 | 40,000 | 20,000 | 20,000 |
| Values carried forward (previous page) | | | 0 | 0 | 0 | 0 | 0 | 0 |
| Values to carry forward (next page) | | | 46,500 | 30,500 | 16,000 | 40,000 | 20,000 | 20,000 |

### Cashbook of Lance's bicycle repair shop

**Month: July**

| Date | No. | Transaction | Cash | | | Bank | | |
|---|---|---|---|---|---|---|---|---|
| | | | Cash in | Cash out | Balance | Bank in | Bank out | Balance |
| Balance carried forward | | | | | 16,000 | | | 20,000 |
| 01.7 | 1 | Reimbursement credit Ferdy K. | | 15,000 | 1,000 | | | 20,000 |
| 01.7 | 2 | Sales repair services | 3,300 | | 4,300 | | | 20,000 |
| 08.7 | 3 | Sales repair services | 5,000 | | 9,300 | | | 20,000 |
| 08.7 | 4 | Sales of material | 7,500 | | 16,800 | | | 20,000 |
| 19.7 | 5 | Transfer cash to bank account | | 10,000 | 6,800 | 10,000 | | 30,000 |
| 25.7 | 6 | Payment credit by Tony R. | 4,000 | | 10,800 | | | 30,000 |
| Total balance (this page) | | | 19,800 | 25,000 | -5,200 | 10,000 | 0 | 10,000 |
| Values carried forward (previous page) | | | 46,500 | 30,500 | 16,000 | 40,000 | 20,000 | 20,000 |
| Values to carry forward (next page) | | | 66,300 | 55,500 | 10,800 | 50,000 | 20,000 | 30,000 |

### Purchases on credit

Name of the customer: Ferdy Bicycle Materials Inc.
Contact information: Wind Mountain, Calibier Street 5, 123 4567
Credit period: 60 days
Credit line: $20,000

| Date | Transaction | Credit amount | Amount paid | Outstanding amount | Signature |
|---|---|---|---|---|---|
| 01.6 | Purchase repair material | 15,000 | 0 | 15,000 | Lance A. |
| 01.7 | Reimbursement credit | | 15,000 | 0 | Ferdy K. |
| 31.7 | Purchase repair material | 20,000 | 0 | 20,000 | Lance A. |

**Sales on credit**

Name of the customer: Tony R.

Contact information: Thuria Village, Flat Street 5, Tel. 998 77 66

Maximum credit line: $5,000

| Date | Transaction | Credit amount | Amount paid | Outstanding amount | Signature |
|---|---|---|---|---|---|
| 17.6 | Repair services | 3,500 | 0 | 3,500 | Tony R. |
| 01.7 | Sales material | 1,000 | 0 | 4,500 | Tony R. |
| 25.7 | Reimbursement credit | | 4,000 | 500 | Lance A. |

# Session 2: Managing finances

This session offers some general recommendations on how to manage a business's finances. It points out the importance of keeping, monitoring and analysing business records conscientiously, drawing an entrepreneur's salary, keeping business finances and household finances separate, and generating savings.

## 2.1 Monitoring income, costs and profit

Entrepreneurs must constantly monitor their finances. They have to know the current state of their business so that they can react as soon as problems occur. This is the best way to limit the risk inherent in any business. These risks include:

- too many sales on credit;
- defaulting customers that received credit;
- too little working capital;
- reduced sales due to tougher competition;
- increased costs of materials;
- deterioration of relations with suppliers due to late credit repayments;
- theft by employees;
- taking too much out of the business cash box for household use.

All of these can put a business at risk. It is important for entrepreneurs not only to keep their records up to date, but also to analyse them. If they realize, for example, that a customer is falling further and further behind with reimbursements, they should stop giving the customer credit until a significant payment has been made on account.

## 2.2 Keeping business finances and household finances separate and paying yourself a salary

It is of the utmost importance for entrepreneurs running a small business to keep business finances and household finances separate. This means that the money required to run the business must be kept physically separate from the money used to cover household expenses. It is best to have physically separate recipients for the cash and/or separate bank accounts (if applicable).

If money is taken out of the business, it must be recorded in the cashbook so that the entrepreneur knows how much cash is around to run the business. The best way to do this is, as mentioned, for the entrepreneur to draw a regular salary.

If too much money is drawn out of the business, the business may run into liquidity problems. This means it becomes incapable of paying its debts and buying the materials it needs. The business cannot operate any more, stops generating profits and, in the worst case, ceases to exist.

Many small business operators do not pay themselves a salary. They just take the money that is left in the cash register. This means that their income is likely to vary significantly from one week to another and that they are not really aware of how much they actually earn through their business. **In fact, this seems to be one of the main reasons why many MEI businesses fail**. One way of preventing this is to introduce a salary for the entrepreneur, i.e. a monthly amount the entrepreneur can take out of the business without putting its operation at risk.

Entrepreneurs are strongly recommended to pay themselves a salary. This forces them to think about how much they believe they should get for their efforts. By monitoring and analysing their records, they can easily determine whether the business is able to generate the salary.

The advantage of a salary is that it regularizes the business transaction and creates a stable pattern of expenses for the business and a stable pattern of income for the entrepreneur. Any profit made by the business should be seen as a bonus.

### 2.3 Building up savings

Entrepreneurs need to save in order to be able to replace expensive equipment once it reaches the end of its economic life-time. If they do not have the means to replace equipment, their business will stall and stop generating income and profit.

Every year, entrepreneurs should put aside an amount equivalent to the annual depreciation of their equipment. Once their respective savings have reached the replacement cost of the equipment, they can stop.

However, there are other reasons for saving money. Life and doing business entail certain risks. One way to protect yourself against risk is to take out insurance. However, insurance is often not available or too expensive. Another way to protect yourself against unforeseen events is to accumulate savings. Entrepreneurs should set money aside for unforeseen events. This money can be used to protect the business (e.g. machine breakdown, spoilage of materials due to water damage) and the family (e.g. sudden illness, breakdown of the stove) against unforeseen events.

If savings exceed the level considered useful to protect the business and the family, the excess can be used for investments or even consumption.

Whenever possible, savings should be kept in a bank account.

Zelimkhan Mestoev/ICRC

## MODULE 8:

# THE BUSINESS PLAN

Module 8 presents a simple business plan the participants can use to summarize the work and calculations they did during the course. All subjects of the business plan have been covered in the previous modules. The trainers will help the participants put the information into the business plan format during the final session.

The business plan gives the course participants an overview of their business and can be used by them and the ICRC as a reference once the participants start operating their businesses.

## Session 1: Putting it all together

The business plan format is presented in *Hand-out 51*. The modules in which the relevant information was covered are indicated below.

**1. Personal information**

**2. Business idea**

Module 2; see *Hand-out 15*.

**3. SWOT analysis**

Module 2; see *Hand-out 20*.

**4. Market description and marketing plan**

4.1 Customers
Modules 2, 3, 4; see *Hand-outs 22, 26*.
4.2 Competitors
Modules 3, 4; see *Hand-out 26*.
4.3 Marketing plan
Modules 3, 4; see Hand-outs 24, 25, 26.
4.4 Suppliers
Module 4; see *Hand-out 26*.

**5. Production plan**

Module 5; see *Hand-outs 32, 33*.

**6. Capital cost**

Module 5; see *Hand-out 32, 33*.

**7. Financial plan**

Module 6; see *Hand-out 41*.

**8. Monthly profit and loss statement**

Modules 5, 6; see *Hand-outs 33, 41*.

## Homework

Formulate your business plan (*Hand-out 51*).

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## MISSION

The International Committee of the Red Cross (ICRC) is an impartial, neutral and independent organization whose exclusively humanitarian mission is to protect the lives and dignity of victims of armed conflict and other situations of violence and to provide them with assistance. The ICRC also endeavours to prevent suffering by promoting and strengthening humanitarian law and universal humanitarian principles. Established in 1863, the ICRC is at the origin of the Geneva Conventions and the International Red Cross and Red Crescent Movement. It directs and coordinates the international activities conducted by the Movement in armed conflicts and other situations of violence.

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