

Ethiopian Business Development Services Network (EBDSN)

HOW TO WRITE A BUSINESS PLAN

Business Planning for Micro and Small Enterprises
Business Planning for Medium Enterprises

Addis Ababa 6/2005



EBDSN



German Technical Cooperation



How to Write a Business Plan

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Business Planning for Medium Enterprises

Addis Ababa, Ethiopia
June 2005

Published by:

Ethiopian Business Development Services Network (EBDSN)
P.O.Box 11133 Addis Ababa, Ethiopia

In collaboration with:

Ethio-German TVET Programme
Ethio-German Micro and Small Enterprises Development Project

On behalf of:

German Technical Cooperation (GTZ)

Project implementation:

GFA Management GmbH, Germany

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1. Business Planning for Micro and Small Enterprises

1.1 Elements of a Business Plan for MSEs

The business plan is the most essential document involved when starting, building and managing a successful business and it is an effective tool for raising the necessary capital as well as capturing the interest of investors. The business plan is the document that clearly and concisely defines the goals and objectives of a business, outlining the methods for achieving them. The business plan is also an excellent communication instrument for investors and suppliers interested in understanding the operations and goals of the business.

Many businesses fail due to the lack of planning and preparation. To help plan for a successful business venture, guidelines in this publication would help an operator better understand what information is needed in the business plan. The more complete and accurate the information, the more promptly institutions, banks, investors, and suppliers will be able to respond to requests for assistance. Generally, the operator himself would be responsible for preparing the business plan.

The business plan describes what the business will do, how and where it will be done, and how the business will be financed and managed. Its basic components include the following chapters:

- personal data;
- work premises at the disposal of the operator;
- yearly sales plan;
- equipment owned and to be purchased;
- yearly raw material requirements;
- yearly operating expenses;
- yearly production/service plan;
- yearly profit and loss statements.

The business plan format outlined below presents all necessary chapters in detail, including all necessary explanations.

7. Equipment currently owned by the operator:

Ser. no.	Type of equipment and year of purchasing	Unit of measure	Qty.	Unit costs	Total costs	Remark
	Total costs of equipment					

8. Equipment to be purchased by the operator:

Ser. no.	Type of equipment	Unit of measure	Qty.	Unit costs	Total costs	Remark
	Total costs of equipment					

9. Yearly raw material requirements:

Ser. no.	Type of raw material	Unit of measure	Qty.	Unit price	Total price	Remark
Total yearly raw material costs						

12. Financial plan:

Capital requirements	Equity	Loan	Total
Investment capital:			
<ul style="list-style-type: none"> • Machinery + equipment • Furniture + fixture • Business premises • Any other initial and significant outlay 			
Working capital:			
<ul style="list-style-type: none"> • Salary/wage • Raw material and/or supplies • Rent • Maintenance • Business promotion • Other cash out of the business to meet short-term and recurrent expenditure 			
Total			

13. Yearly Profit and Loss Statement

Company	
Profit and Loss Statement	
Period: from..... to.....	
Gross Sales	
Less: Returns and allowances	-
= Net Sales	=
Less: - Costs of goods sold	-
- Direct material	-
- Direct labour	-
- Overhead	-
= Gross Profit	=
Less: - Administrative and selling expenses	-
- Salaries	-
- Telephone	-
- Water	-
- Electricity	-
- Rentals	-
- Others	-
= Operating Profit	=
Less: - Interest expense	-
= Net Profit before Tax	=
Less: - estimated Income Tax	-
= Net Profit after Tax	=
Date	
Signature	

1.3 Instructions to the Business Plan Format

In order to write the business plan, please download the Winword.doc format that can be found in the business plan web page

www.bds-ethiopia.net/business-plan.html

The table of the business plan has to be complemented with more lines, if necessary.

Help to 1 and 2: In this section in addition to writing the name of the business operator the essential thing is that the business owner has to have a personal assessment which enables him to identify his entrepreneurial talent, skills both technical and business and other personal factors which contribute to the success of the business.

Help to 3: Write down the type of business/activity in which the operator is engaged /would like to be engaged. In this section the following issues have to be addressed : the licenses and permits needed, the business type / merchandizing, manufacturing or service/, the type of product or service, factors which ensure the profitability of the business and the working days have to be included. But for micro enterprises such kind of information have to be indicative, detail analysis is not required.

Help to 4: Fill the starting and termination date of the planning period, specifying the date, month and year. During the implementation of the planning period there is a need by the business operator to revisit what is indicated in the business plan and make adjustments accordingly. Preparation of business plan is an ongoing process.

Help to 5: The location of the business can play a decisive role in its success or failure. Explain the work premises and other utilities at the operator's disposal and describe the specific working premise problems, the space needed for the business , the desirable features of the location and its accessibility to the market. If there is anything in the location that is of special interest for your business you can stress it, too.

Help to 6: The key issue in sales performance or marketing as a whole is to know better the likes, dislikes and expectations of customers. The yearly sales should be planned based on certain market surveys or past experience, if any is available. The market surveys will indicate the age, sex, income/educational level and residence of customers . But focus has to be given to those customers who are likely to purchase the product/service of the enterprise. Planning the yearly sales enables to find out about the desired production amount (it makes no sense to produce more than you can sell) and the yearly income. Describe the months during which sales are expected to be high, in order to make the necessary preparations ahead of time and exploit the advantage. For defining the unit price per product/service you should first know the unit costs (see production costs) as

well as the prices of your direct competitors. In addition there is a need to identify the strength and weaknesses of competitors in their product quality/quantity and identify how their product/services differ from yours, their pricing and advertising techniques. So probably you will at first fill only columns I-III, to define the possible production amount and after counting the costs per unit you can define the price per unit.

Help to 7: Knowing the possible amount of products/services you can sell, you are now able to plan your desired production capacity, hence the machinery you will need for this amount. If you have already some equipment, then describe it here. Multiplying the quantity of the specific equipment by its unit cost will give you the total cost of the equipment. Depreciation is the theoretical price to the use of an asset. You need to know it to count later the costs of your product/service. One of the various methods of defining yearly depreciation, and the simplest one, is to divide the purchasing price of the asset by the number of years of usage.

Help to 8: List down the equipment of production/service planned to be bought by the operator. Multiplying the quantity of the specific equipment to be bought by its unit price will give you the total costs of the equipment. Based on the market survey the product issues that need to be considered are: the productivity and precision of the equipment to produce quality products, the ease to repair/install and the skill required, the space needed for installation and the availability of spare parts.

Help to 9: Describe the yearly required raw material specifying the type of raw material, the quantity needed, unit and total costs. Indicate the source and continuous availability of raw material, whether it is self owned, obtained from the local market or imported from abroad.

Help to 10: The general yearly operating expenses should be explained in order to know production costs and determine the price of the product or service. Unit costs are composed of material, labour, production overheads, administration and marketing costs, if the production of one product is in place. For several products: divide the production costs by the number of products.

Help to 11: If logically planned, then columns I-III are the same as the yearly planned sales plan chart (see 6). If you multiply the quantity of production/service planned by its unit cost you will obtain the total cost of production or service. To define the unit costs you have to add the fixed costs per unit and variable costs per unit. Fixed costs are usually: administration expenses (telephone, fax), stationery, rent, electricity, water, transport, public services, maintenance, advertisement, depreciation, entrepreneur's salary/ wages and salaries (not piece wage!). Variable costs usually include:

raw material, salary per produced piece (hint: for more details about counting the unit costs refer to the booklet on "Accounting and Cost Calculation" published by the same editor).

Help to 12: The yearly working capital may be estimated on the basis of a three-month calculation of costs. Working capital is mainly required to cover costs related to raw material, salaries, simple hand tools of temporary nature and other operational as well as administrative expenses. In addition, costs related to marketing activities such as sales promotion and advertisement are also covered by the working capital.

Once you have determined the purpose and amount of the total capital you need, it would then be necessary to know the sources of that capital. You may have more than one option to secure the type of capital you need for your business. Nevertheless, it would be necessary to choose the one with easy access and less cost. Do not forget or underestimate your own contribution to your total capital needs. Part of the capital (termed as equity), therefore, is your own fund coming from regular and purposive savings. In most cases, this amount may not be sufficient to respond to your total capital requirement and you may need to solicit loans from other sources such as commercial banks or micro finance institutions. If this is the case, it should be necessary for you to determine the exact amount of the loan you must borrow and its financial expenses in terms of interests and repayment.

Help to 13: in order to determine the yearly gross profit, subtract all the appropriate yearly expenses from the yearly sales revenue. If the yearly tax expenses are subtracted from gross profit, the net profit will be obtained.

Instruction to the Profit and Lost Statement

The Profit and Loss (P+L) Statement is one of the financial analysis tools employed by business enterprises to track the performance of their enterprises. The P+L statement is the difference between sales and expenses of an enterprise over a given period of time, often one year. If this difference is positive, it is termed profit, while if it is negative, it is then termed loss.

The P+L statement is important for business operators/managers in checking the efficiency of their business strategies and taking proper actions. The statement is also important for bankers to check business profitability before extending credit. The statement can only be drawn up based on certain source documents such as the cashbook, otherwise it would be very difficult to apply, especially for micro enterprises. For the statement to be

applied in a given enterprise a certain level of accounting system is needed to be in place. The P+L statement has the following components:

- **Gross sales:** the total value of sales which is obtained by multiplying the price of each product with the total units of output sold.
- **Returns and allowances:** stands for the value of damaged goods that are returned by customers to the business enterprise for which the business replaces the damaged goods with new. It also considers payments made as sales commissions, discounts, etc., which again are deducted from Gross Sales to result in Net Sales.
- **Costs of goods sold:** stands for the costs involved with regard to direct labour, direct material and factory overhead costs which are deducted from Net Sales to arrive at Gross Profit
- **Direct material:** stands for those material costs directly accrued in the production process, such as raw material.
- **Direct labour:** refers to costs of all labour inputs directly used in the production of goods/services of a given enterprise. Often direct labour costs are measured on unit rates and costs of daily labour.
- **Overhead costs:** stands for those costs incurred, but which are not directly related to the production process. E.g. depreciation of machinery or equipment, shade rent, etc.
- **Administrative and selling expenses:** This includes costs incurred for certain administrative purposes and for the distribution of products. These are deducted from Gross Profit to arrive at Operating Profit. These expenses are for example, salaries of management and support staff, expenses related to telephone, water and electricity bills as well as office rents and other similar expenses.
- **Interest expense:** this is the amount of interest to be paid on the amount of loan obtained, based on the current interest rate.
- **Estimated income tax:** the amount of tax that has to be paid as per the income tax proclamation.

2. Business Planning for Medium Enterprises

2.1 Elements of a Business Plan for Medium Enterprises

The business plan is the most essential document for starting, building and managing a successful business and is an effective tool for raising the necessary capital and capturing the interest of investors. The business plan is the document that clearly and concisely defines the goals and objectives of a business and outlines the methods for achieving them. The business plan is also an excellent communication instrument for investors and suppliers interested in understanding the operations and goals of the business.

Many businesses fail due to a lack of planning and preparation. To help plan for a successful business venture, the below-prepared guidelines should help an operator better understand what information is needed in the business plan. The more complete and accurate the information, the more promptly institutions, banks, investors, and suppliers will be able to respond to requests for assistance. Therefore a business plan need to be persuasive .Generally, the operator himself would be responsible for preparing the business plan.

The business plan describes what the business will do, how and where it will be done, and how the business will be capitalized and managed. Although there are many types of business plan formats based on what it is needed for, basic components include the following chapters:

- Executive summary
- Sales and Marketing
- Production
- Organisation and Management
- Financial plan

The business plan outlined below presents all necessary chapters in detail, followed by an instruction to each of the chapters.

Business Plan Outline for Medium Enterprises

Executive Summary

- A. Brief Description of the Project
- B. Brief Profile of the Entrepreneur
- C. Project's Contributions to the Economy

1. Sales and Marketing

- 1.1 Product description
- 1.2 Competitors'
- 1.3 Location
- 1.4 Market Area
- 1.5 Main Customers
- 1.6 Total Demand
- 1.7 Market Share
- 1.8 Selling Price
- 1.9 Sales Forecast
- 1.10 Promotional Measures
- 1.11 Marketing Strategy
- 1.12 Marketing Budget

2. Production

- 2.1 Production Process
- 2.2 Fixed Capital
- 2.3 Life of Fixed Capital
- 2.4 Maintenance and Repairs
- 2.5 Sources of Equipment
- 2.6 Planned Capacity
- 2.7 Future Capacity
- 2.8 Terms and Conditions of Purchase of Equipment
- 2.9 Factory Location and Layout
- 2.10 Raw Material Needed
- 2.11 Costs of Raw Material
- 2.12 Raw Material Availability
- 2.13 Labour
- 2.14 Costs of Labour
- 2.15 Labour Availability
- 2.16 Labour Productivity
- 2.17 Factory Overhead Expenses
- 2.18 Production Costs

3. Organisation and Management

- 3.1 Form of Business
- 3.2 Organisational Structure
- 3.3 Business Experience and Qualifications of the Entrepreneur
- 3.4 Pre-Operating Activities
- 3.5 Pre-Operating Expenses
- 3.6 Office Equipment
- 3.7 Administrative Expenses

4. Financial Plan

- 4.1 Project Costs
- 4.2 Financing Plan and Loan Requirement
- 4.3 Security for Loan
- 4.4 Profit and Loss Statement
- 4.5 Cash Flow Statement
- 4.6 Balance Sheet
- 4.7 Loan Repayment Schedule
- 4.8 Break-even Point (BEP)
- 4.9 Return on Investment (ROI)
- 4.10 Financial Analysis

Instruction to the Business Plan for Medium Enterprises

Cover page

The external appearance has its own contribution in communicating the content of the business plan. The information included in the cover sheet must be simple highlighting the name of the company with full address (telephone, fax, e-mail and name of person to be directly contacted for further question with the date of business plan preparation), company logo if there is one with limited size and at the centre the word business plan preceded by the company name should appear. The second page will be for table of contents and it is highly preferable that it will be limited to one page.

Executive Summary

The Executive Summary, although appearing first in the order of presentation in the Business Plan, is actually the last to be prepared, that is, after the four sections of the business plan (marketing, production, organisation & management, and finance) have been completed. It should be short (not more than two pages and single spaced), however, loaded with vital information about the project.

1. What is the Nature of the Project?

Briefly describe the project – Benefits of the product/service and the need identified and why the need exists, trends and risks of the market and who are the customers and the expected market share, competitive advantage and key suppliers and technological change in the industry, location of business and zoning laws, legal form and historical background of the business, plan of operation and main financial indicators such as projected and actual sales earnings and profit after tax.

2. What are the Entrepreneur's Competencies and Qualifications?

Give a brief introduction of yourself as an entrepreneur, your background, your past track record, business experience and training, especially mention those skills, qualities, networks and contacts with persons/enterprises needed by or related to the project, and how you plan to use this knowledge and skills to successfully run the business.

3. What are the Project's Contributions to the local and national Economy?

Describe the important socio-economic and developmental contributions of the proposed project to the local and/or national economy. These contributions should be significant factors and priority concerns of the government, banks and society in general. These contributions may include employment generation, utilisation of local skills and materials, income generation, import substitution, export earnings, etc.

Sales and Marketing

1.1 What is the Product?

Give a short description of the product, its size, colour, shape and the range of products to be offered. Describe product features, uses and benefits, whether it is a new or an existing product. The technology with the required training and the raw materials used to make the product has to be described in line with the market demand and potential competitors. The

terms and conditions, volume, quality and price of potential suppliers of raw materials has to be stated. To ensure sustainability future products/services to be offered has to be identified and described briefly.

1.2 How does it compare in Quality and Price to its Competitors?

In answering this question, determine what will make the product unique in the market. Will it be of better quality as compared to what is currently available, or will the price be significantly different to make it easier to sell? What other features will make it different from your competitor's products?

1.3 Where will the Business be located?

Location of the business is essential to either reduce costs or to increase the chances of customers stopping at the business to look at your products or at least make inquiries. If the business is retail or service oriented, it must be near to the market. If it is production oriented, it may be better to be closer to its raw material sources or near necessary infrastructure facilities (e.g., port), transport and utilities (e.g., power) centres. The important factors to consider with regard to location are:

- proximity to essential raw material sources;
- proximity to markets and distribution channels;
- availability of transport facilities;
- availability of efficient and cheap skilled labour;
- existence of related industries (forward/backward linkages);
- infrastructure facilities (e.g., road, power, port, etc.);
- communication facilities (e.g., post office, telephone, fax);
- zoning regulations and growth features;
- cost and conditions of acquiring the land.

A good location is one of the most crucial factors essential for market development hence the choice of location should therefore be carefully considered. The location should also be differentiated in terms of marketing outlets or factory locations.

1.4 What geographical Areas will be covered by the Project?

Determining the geographical coverage (that is, where to market the product) depends very much on the nature of the product; how well it lend itself to transport and distribution; the size of the market in different localities; the presence of strong competitors in the areas under consideration; your willingness to travel and, of course, on existing contacts or channels of distribution you are familiar with. In general, it is easier to deal with a limited market area, since travel time and distribution costs can be kept to a minimum.

1.5 Within the Market Area, to whom will the Business sell its Products?

Here we are talking about a specific target group or market segments among the population, within the specified market area you have chosen, to whom you will aim to sell your products. Identify these customers as clearly as possible (e.g., their characteristics and profile in terms of age, sex, income, buying practices, consumption pattern, etc.), in order to ensure that the product does indeed suit their taste, needs, wants, income, lifestyle.

Will you sell to wholesalers, retailers, and if so, what are the consequences? If you plan to have a retail outlet, the choice of location is critical.

1.6 Is it possible to estimate how much of the Product is currently being sold?

This estimate should be possible to carry out in a number of ways. Basically, the approach is to move from the general to the particular. For example, you can start by estimating consumption, usage or sales of the product per head of the population in your market area.

Then, one by one eliminate certain segments (specific groups categorised by age, income, location, sex, habits, etc.) of the population who may not be your consumers, so that at the end a reasonable figure can be assumed to be correct. If possible and available, it is also good to check certain statistics. If you cannot make use of any reliable statistics (secondary data), it may be better to carry out a simple and low-cost sample survey, i.e., gather firsthand or primary data. For example, if you know how many shops there are which sell your or similar products, and if you question a few of them regarding their sales, you can estimate the total sales of the product.

1.6.1 Market Survey Checklists

The following is a series of checklists which can guide you in your interview with wholesalers, retailers, and consumers (people who use the product) or customers (people who buy your product). The questions are intended to be illustrative and you should learn how to begin your interview (by being friendly with your interviewees so that they will open up and not feel suspicious or threatened) and pose your questions diplomatically, politely and clearly to attain the desired information and accurate answers.

If the questions are adequately answered, you can make a preliminary estimate of the total demand in your market area and the share of the market which you can realistically capture, given an effective marketing strategy. If similar products are distributed mainly by wholesalers and retailers, conducting such a survey is really the first step in establishing a relationship with your customers and finding out their needs. There are two main reasons for carrying out the survey:

- a) Accurate collection of information, so that a reliable level of sales and production can be forecasted;
- b) Establishment of good relations with your own potential customers.

1.6.2. Wholesalers'/Importers' Checklist

Most consumer products such as biscuits, sugar, toothpaste, matches, etc. find their way to the consumers by means of wholesalers who purchase the goods in bulk from a factory or distributors and then sell them in smaller quantities to grocery stores and retail shops (customers). Since there are usually few wholesalers and many retailers, it is often best to start your market survey by visiting the wholesalers. Once you have defined your market area, try and locate all the wholesalers who supply your area and ask the following questions:

- 1) How many wholesalers are there in your market area? What are their names and where are their locations?
- 2) What market areas does each wholesaler cover?
- 3) How often does each of your products sell per year? Are your sales of the product increasing every year? If yes, by how much?
- 4) Are seasonal fluctuations present?

For example: 1 2 3 4 5 6 7 8 10 11 12 months
High
Medium
Low

- 5) What about the extent of competition? Are they large in size, are their product features the same, what are their quality standards? What are their marketing practices?
- 6) What about product improvements, i.e. do they think the market needs some new designs, more varieties, better features, new product specifications?
- 7) What are their selling prices of your products?
- 8) At what price do they buy them?
- 9) What is the length of credit extended to them by their suppliers (one week, one month?), if any?
- 10) Assuming your product is of suitable quality and priced competitively, how much of your product would they take as a sample order?

1.6.3. Retailers' Checklist

Retail shops are the last link between producers and consumers. Ultimately, they make the final sale to the public. Their proximity to the buyers makes them valuable sources of information on what people actually want and buy.

For example, if a person buys ink that turns out to be of poor quality, then the customer will complain to the shop where he purchased it, rather than going to the factory. For this reason, retailers are in a strategic position to identify gaps within the market, particularly between what the customer's demand is and what his wholesalers can supply. A few creative retailers may be able to give you new product ideas that could also be realised in your factory.

The objectives of interviewing retailers are:

- a) To cross-check data provided by wholesalers;
- b) To learn about the needs, wants, tastes, buying habits, etc. of the consumers;
- c) To look for potential new products;
- d) To learn how to position your product as against your competitor's products;
- e) To learn how to market your product more effectively;
- f) To help identify promotional measures that will be useful in selling the product (e.g. display boards, give-aways, samples, etc.);
- g) To help formulate the marketing strategy of the business.

A few questions which may be asked from the retailer:

- 1) How much of the product does he sell in a year?
- 2) How many competitors does he have in his neighbourhood?
- 3) Does he experience any seasonal fluctuation in sales?
- 4) From what wholesaler or manufacturer does he buy the product?
- 5) Is he given any credit by his suppliers?
- 6) If he is given credit for the product, for how long is the credit given?
- 7) Does he sell on wholesale anywhere, if so, where?
- 8) What is his purchase price of the product?
- 9) What is his selling price of the product?
- 10) Does he have any ideas whether his customers would like some changes or improvements of the product?
- 11) Does he buy the product by means of cash or on credit?
- 12) Does he sell on commission?

1.6.4. Customers' or Consumers' Checklist

Even if you have interviewed wholesalers and retailers, it is important to discuss market acceptance with customers (who buy the product) and consumers (who use the product). Their feedback is very useful, either to cross-check previously collected opinions or to capture new ideas that neither of the other two groups of interviewees have touched on or reflected.

In particular, if your product is a capital good (e.g., machinery), it is necessary to talk to consumers as they normally purchase directly from the factory. A few questions which can be asked from customers and consumers are:

- 1) Why did you buy this product?
- 2) When (What month) did you buy it?
- 3) How often do you buy this product?
- 4) Will you need more of this product in future? How many units?
- 5) How much did you pay for it?
- 6) Are you satisfied with it?
- 7) Would you like to see any changes or improvements?
- 8) From where did you buy it (locality), from whom?
- 9) Why did you buy it from this particular supplier?

You must have a profile record of your interviewees (wholesalers, retailers, consumers), including information such as age, occupation, income, buying habits, sex, consumption patterns etc., as this information will be helpful in analysing and describing your market.

1.7 What Share or Percent of this Market can be captured by the Business?

This is always a difficult question to answer precisely, since much depends on your ability as an entrepreneur to sell your product, your network, the effectiveness of your marketing strategy and your aggressiveness in pushing the product combined with business common sense. It also depends on the extent and strength of competition. However, certain guidelines can be given. If you have done your market survey properly, you will know the following information on your competitors:

- a) whether there are few or many competitors;
- b) whether they are large or small in size;
- c) whether their product features are similar or different to one another;
- d) whether their product features are similar or different to yours.

The following decision guide may help in processing this information to make an estimate of your market share.

Decision Guide			
Number of Competitors	Their Size *	Their Product Features	Market Share (in %)
Many	Large	Similar	0 - 2,5
Few	Large	Similar	0 - 2,5
One	Large	Similar	0 - 5
Many	Large	Dissimilar	0 - 5
Few	Large	Dissimilar	5 - 10
Many	Small	Similar	5 - 10
Few	Small	Similar	10 - 15
One	Large	Dissimilar	10 - 15
Few	Small	Dissimilar	20 - 30
One	Small	Similar	20 - 50
One	Small	Dissimilar	40 - 80
Total			100

* Assumed that your business is in the "small" category when entering the market.

1.8 How much of the Product will be sold?

Now that you have estimated the market share you can realistically capture, make an estimate of your targeted sales (sales forecast), that is, every month for the first year and yearly for the next five years. The first annual sales forecast is generally a fraction of the estimated market share and could be anywhere from 60 to 80% of the market share at the beginning. This is to take certain errors in estimating the market into consideration.

1.9 What is the Selling Price of the Product?

There are three common ways of determining the selling price of your product. These are:

a) The "Cost-plus Method"

This is done by adding a reasonable profit margin (say 20% to the final total product costs (i.e., marketing costs plus production costs plus administration costs, plus finance costs). The final product costs per unit are determined by dividing the total product costs by the number of units produced. To this figure you may add a profit margin.

b) The "Comparative Method"

This method compares your product with others in the market and then, based on your product's quality and other features, you may fix your price lower, higher or at the same level as your competitor's price.

c) "What the Market will bear Method"

This method is based on supply and demand of the product. For instance, if there is a scarcity of the product in the market (sellers' market), you can set your selling price at a high level; hence your profit margin could be higher. Similarly, if there is a surplus of the product in the market (buyers' market), you may be forced to lower your price, and consequently your profit margin. (Two alternatives to avoid reducing profit margins are: (1) to reduce the product costs by identifying which areas under marketing, production, administration and finance can be reduced), and (2) to identify other market segments that can afford to buy at the original price).

In practice, all three methods should be used from time to time in any business, but in general and especially when starting a business, it is safer to use the "Cost-Plus Method". It is also a good business strategy to anticipate your competitor's reaction to your pricing strategy.

1.10 What promotional Measures will be used to sell the Product?

Promotion is one of the most neglected aspects of marketing a product. Promotion is necessary to entice and convince buyers into purchasing your product and not those of your competitor. Promotion is generally divided into advertising, sales promotion, publicity and personal selling. A few of these measures are:

- radio advertisements, newspapers, magazines, trade journals or, if appropriate also via television,
- volume discount (reduced prices when selling in bulk);
- handbills distribution;
- prompt, regular, courteous and efficient service;
- good merchandising ensuring the proper display of your product on the shelves of your market outlets;
- special credit facilities to regular customers;
- posters; billboards; signboards;
- free samples; free trials;
- press releases;
- buy one - take two;
- raffles; coupons;
- sponsorship of local shows, festivals;
- participation in trade fairs and exhibitions;
- personal selling.

One word of caution on promotional measures: These activities cost money to your business, so be sure that for every promotional measure adopted, there is a foreseeable increase in sales. Without a justifiable increase in sales, costs will escalate, hence increasing the unit costs of the product. Make sure to include these costs in your marketing budget.

1.11 What Marketing Strategy is needed to ensure that Sales Forecasts are achieved?

Formulating a marketing strategy means proper planning, balancing and integration of the business's product strategy, pricing strategy, distribution strategy and promotion strategy. In order to market effectively, you must identify your market, know your product and study your competitors. You also have to spend a certain amount of time on promotion activities, pricing your products correctly and distributing them to your retailers and/or consumers effectively and efficiently. You should not assume that because your product is good that customers will automatically buy your product.

1.12 How much do you need to promote and distribute your Product?

You must have a marketing budget that includes your marketing costs, such as for promotion, distribution and salaries of your sales force, if any.

Production

2.1 What is the Production Process?

In order to find out what costs (labour, raw material and overheads) are involved in production, it is useful to follow the whole production process and to identify how the raw material are received and gradually, step-by-step, transformed through various processes (e.g., cutting, mixing, assembling, finishing, packaging, etc.) into a finished product. Description of the process need not be a lengthy explanation, but should cover all the major operations. A process flow chart is a useful tool to depict the production process. This will also clarify how many workers are required at each stage and what skills are needed.

2.2 What Building and Machinery (fixed Assets) are needed and what will be their Costs?

Identify these items carefully and estimate their costs accurately. If the requirements are over-estimated, the results can either be:

- a) Too much production occurs and stocks are built up - this costs money and ties up capital uselessly and unnecessarily;
- b) Excess capacity means that you are investing in certain assets or paying interest on building and equipment that are not providing you with any return. This will also increase costs in the long-run by having a higher depreciation than necessary;
- c) There is also the possibility that the project may not be financed at all because it appears too expensive.

In general, it is better to start on a very modest scale with a small building, or even rented space, and with the minimum essential machinery. Remember, if the demand for your product exceeds the 8-hour capacity (one shift) of the equipment, an extra shift can be added at a later stage, or you can operate on overtime after the regular shift has ended. Especially when starting a business, proceed with capital purchases with extreme caution and only when the market is secured.

Regarding machine capacity the supplier should give the correct information to the entrepreneur. In many cases, suppliers tend to over-rate the capacity and efficiency of their machinery; so do not count on the machines working at 100% rated capacity. By determining the realistic capacity of each machine, it is then possible to estimate accurately the proper balancing of the machines and men, i.e. how many of each tools or machines are required, and correspondingly the workers and skills required operating the machines to ensure a smooth and efficient production operation.

Determining the costs of building and machinery should be relatively easy, since every entrepreneur can find out this information from machinery suppliers. Again, you should be cautious not to build fancy buildings or obtain equipment which is too modern or too sophisticated to operate and maintain. Machinery salesmen usually try to sell the most expensive or most modern equipment first, so be aware of what you need and can afford, and do not be led into purchasing equipment which may not be essential or even suitable to your scale of production, especially in the initial stages of your operation.

Be aware that there may be a wide range of technology options ranging from labour-intensive (more labour is required relative to the number of machines or investment in machines) to capital-intensive (more machines are used or higher investment in machines relative to the labour required).

If quality labour supply can be assured, it is often wise to use labour-intensive technology, since your factory will be less dependent on its machines, which can break down at any time, suffer from power failure, and be idle for lengthy periods. If, on the other hand, labour is troublesome and unreliable due to seasonal availability, a more capital-intensive approach on a modest scale may be more practical. However, if workers are properly motivated, they can be encouraged to become more reliable.

Finally, list all the land and improvements, building, furniture and fixture, machinery and factory equipment including installation costs, stating their size, capacities and costs, to eventually arrive at the total costs of fixed assets.

2.3 What is the useful Life of the Building and Machinery?

The answer will depend on the make of the building (i.e., whether made of wood, concrete structure, etc.) and machinery and on how much you use

your fixed assets. To arrive at an annual depreciation charge, deduct the scrap value at the end of its expected life, and then divide the value of the asset by the number of years of its productive life. If it has no scrap value, simply divide the value by the number of years.

In your country, the Tax Office publishes general rates of depreciation. In many countries, general practice is as follows, although certain variations may exist:

Fixed Asset	Life	Annual Depreciation
Machinery	10 years	10%
Building	20 years	5%
Furniture	5 years	20%
Vehicle	7 years	15%

2.4 How will Maintenance be done and are Spare Parts available locally?

It makes little sense to import equipment which, although it may be more dependable, may result in long work stoppages while you wait for the arrival of spare parts from abroad. Maintenance service and spare parts should be available locally to ensure continuous production. Do not forget

to estimate the costs of maintenance and spares, as this will form part of the production costs. Maintenance costs are part of factory overhead expenses.

2.5 When and where can the Machinery be obtained?

It is necessary to check with machinery suppliers. Estimate accurately the delivery time of the machinery, as this is vital in preparing your pre-operating schedule. Also, do not forget to include in the costs of the machinery, the transport costs to the factory, import duties (if imported), insurance up to the point of installation and installation charges, if any.

2.6 How much Capacity will be utilised?

100% capacity utilisation normally means that the equipment is working eight hours a day, six days a week. Most factories work on an 8-hour, one shift basis and many of them use their equipment for only a portion of this time. Seasonal fluctuations in capacity utilisation should be accounted for. A good example is a brick factory where operations may run continuously for 24 hours a day during the construction season and may be shut down for six months due to rainy season.

2.7 What are the Plans for using Spare Capacity?

Machines and equipment should be used as much as possible. This keeps the workers in a steady rhythm and the equipment in good running order. During periods where low capacity utilisation is foreseen, attempts should be made to ensure that other works (e.g., product improvement and development) are undertaken, which may not at first be directly related to the main production, but which at a later stage may be developed into a new product.

2.8 When and how will the Machinery be paid for?

Certain machinery suppliers are prepared to sell their equipment on hire-purchase scheme. This spreads the costs of the machinery over a longer period of time, resulting in higher total costs, but it enables the business to have greater cash liquidity or lower investment requirements during the start up period. Before purchasing the equipment, find out the terms of sale, i.e. whether cash, credit, or leasing, the length of payment and other conditions, such as guarantees, after-sales services, training of operators.

2.9 Where will the Factory be located and how will the Factory be arranged?

Almost always in small and medium industries the factories have the same location as their business addresses.

Equally important is to determine the floor space required by the business (for production, office, store room, toilet, etc.) and more importantly how the factory space is going to be laid out in terms of the spatial arrangement of the machines and equipment. To answer this question, it is essential that you must know the production process and the machines/equipment needed for each process, so that you can arrange the machines according to the production flow as much as possible.

You can also determine the size of the machines and the space they will occupy (including allowance for movement). A plant layout will be very useful for this purpose. You can arrange your machines in a straight line or a U-shape.

2.10 How much Raw Material is required?

Now that you have a good idea of the production level you want to achieve, find out the type, quality and quantity of raw material needed. Find out the input-output ratio or conversion ratio, e.g. how many kilos of oil would be required to produce 120 kg of soap per day. These should be specified according to square meter, kilo, ton, pieces, etc., which will be used per month.

2.11 How much will the Raw Material Cost?

After determining the quality and quantity of the needed raw material, find out their unit costs (i.e., LC2,000 per ton, LC15 per square meter, etc.), list these costs next to the material and prepare a list of average monthly raw material requirements and their costs. Include duties and relevant taxes, if raw material is imported.

2.12 What are the Sources of Raw Material? Are they available throughout the Year?

In sourcing raw material, at least three factors are critical. Firstly, the price should be as low as possible. Secondly, their source should be as close as possible to the production site to reduce transport costs. Thirdly, the source should be reliable.

If raw material is not available throughout the year, at least two alternatives are possible - either the factory will have to reduce production or it must build up a stock of raw material when they are available and plentiful, so that production can be continuous. If the latter is chosen, additional working capital is required and should be included in the calculation of your cash needs and determination of your project's investment requirements, so that the business can cope with this situation. For example, think of the problem involved in obtaining fruit for a fruit processing plants during off-season!

2.13 How many direct and indirect Workers are needed and what Skills should they have?

Labour in a factory is divided into direct and indirect labour. Direct labourers are those who are directly or intimately involved in the production process. Indirect labourers are all further workers who facilitate production such as utility men, foremen, maintenance workers, among others, who are not directly involved in production.

To determine the number and type of direct labourers needed, break down their skills into three categories: skilled, semi-skilled and unskilled. Their salary scales should be calculated accordingly.

2.14 What will be the Costs of Labour?

Estimate how much each worker (for example, from the production supervisor/foreman down to the production worker, maintenance man, utility man) should receive on a monthly basis. Labour costs should include effective total labour costs to cover basic salaries, wages, fringe benefits, paid leaves, free meals, social and medical insurance, etc. In certain cases, direct labour will be paid according to piece work. If this is the case, estimate the production output of the worker and multiply this number by the respective piece rate.

2.15 Are Workers available throughout the Year? If not, what Effect will this have on Production?

Many factory workers in small and medium businesses receive low wages and, therefore, supplement their income with agricultural or other extra external jobs. If this is the case, the business must be ready to cope with such a situation and, either pays its workers competitive or a higher wages/salaries/piece rates, or recruit new or temporary workers during this period, or even be prepared to reduce production. Whatever course of action is decided upon, it must be accounted for in determining the production schedule.

2.16 How will the Workers be motivated?

Workers can be motivated in a number of various ways: humane treatment, good working environment, increased responsibility, other incentives (e.g., profit sharing, awards for deserving workers, bonuses and providing facilities, such as meal and snack allowances, transport allowances, medical allowances, lodging, etc.) If these are given, their costs should be calculated and included in computing actual labour costs or as overheads.

2.17 What Factory Overhead Expenses are incurred?

Factory overhead expenses include such costs as rent of factory space, maintenance and repair costs, depreciation of factory machines and equipment, costs of utilities (water, electricity, and salary of supervisors, cleaners and maintenance men). In the case of electricity, if it is used in a large quantity and the amount used depends directly on the level of production, it should be treated as a raw material rather than as an overhead expense. But if electricity is only used for lighting and general purposes, treat it as an overhead expense.

Only the costs, such as those listed-above that do not change or vary much according to the level of production are treated under overheads.

2.18 What are the Production Costs per Unit?

Production costs include the costs of direct raw material, direct labour and factory overheads. Two methods are mentioned here to calculate production costs per unit, as follows:

Method 1

To arrive at the production costs per unit, add the monthly costs of direct raw materials (step 2.11), direct labour (step 2.14), and overhead expenses (step 2.17), then divide this amount by the number of units produced during the course of the month (step 2.6).

Method 2

It is unfortunate that in real life costing is not quite as simple as illustrated above. The complication arises from the fact that few small and medium industries produce only one item for sale. Whereas it may be easy to identify the raw material costs in any one item, estimating the labour content or allocating a portion of the overheads to a particular item presents another problem.

Allocating Labour Costs:

To assign direct labour costs to any product, follow this simple rule: Multiply the hourly direct labour charge by the number of hours of direct labour that goes into manufacturing the product. The hourly direct labour charge is derived by dividing the total direct labour costs by the number of hours of direct labour available. For example, if 8 direct labourers work 8 hours a day, 6 days a week for 4 weeks, then the total hours of direct labour available per month is:

$$8 \text{ workers} \times 8 \text{ hrs/day} \times 6 \text{ days/week} \times 4 \text{ weeks} = 1,536 \text{ hrs}$$

If the total costs of these direct labourers amount to LC4,000, then the hourly rate (LC) is:

Total direct labour costs of LC4,000/1,536 hours available = LC2.60 per direct labour hour (hourly rate).

Example:

If a chair requires 6 hours of direct labour to manufacture, then the direct labour costs of that chair lies at:

$$\text{Hourly rate of LC2.60} \times 6 \text{ hours} = \text{LC15.60}$$

Allocating Overhead Expenses:

There are two ways of allocating overheads. These are:

- a) by relating overheads to labour hours,
- b) by allocating them in relation to sales.

The first and preferred way is to relate overhead expenses to the hours of direct labour involved in manufacturing the product. This can be done by dividing the total overhead expenses by direct labour hours available and then multiplying this amount by the number of hours it takes to manufacture the product.

Example:

If total overhead expenses amount to LC3,000 and total direct labour hours are 1536 then the hourly overhead rate is:

Total overheads of LC3,000/1536 total hours = LC1.95 per direct labour hour (Hourly overhead rate). Then, multiply the hourly overhead rate by the number of direct labour hours used to make the product:

Hourly Overhead Rate of LC1.95 x 6 hours to manufacture one chair = LC11.70

This figure can then be added to the raw material and direct labour charge to arrive at the unit production costs of the product. The second method of allocating overheads is according to the % of sales of that particular product in relation to total sales. If, for example, a furniture maker produces the following products:

Products	Unit Selling Price (LC)	Sales per Month	% of Sales
20 chairs	LC 200	4,000	20%
10 beds	LC 400	4,000	20%
12 tables	LC 1,000	12,000	60%
Total Sales		LC20,000	100%

Total sales are LC20,000 of which 20% are chairs, 20% beds, and 60% tables. Therefore, 20% of overheads could be allocated to chairs. The overhead charge per chair can then be calculated as follows:

Total overheads for 20 chairs lies at:
 Total overheads per month of LC3,000 x 20% = LC600
 Therefore, the overhead charge for each chair is LC30:
 LC600/20 chairs = LC30
 Similarly, for beds, it is:
 LC600/10 beds = LC60

And for tables:
 LC600/12 tables = LC150

After having determined the raw material costs per unit, the direct labour costs per unit and the overhead rate per unit, the unit production costs can be calculated by adding all of these three cost components:

+ Unit Raw Material Costs
 + Unit Direct Labour Costs
 + Unit Factory Overhead Costs
 = Unit Production Costs

Alternatively, unit production costs can be derived from the following calculation:

+ Total Raw Material Costs
 + Total Direct Labour Costs
 + Total Overhead Costs
 = Total Production Costs divided by Total Production Volume
 (e.g., kg or units)
 = Unit Production Costs

Organisation and Management

3.1 How will the Business be organised?

There are four common forms of business organisation: (1) sole proprietorship, (2) partnership, (3) private limited company (closed corporation), and (4) public limited company (public corporation).

However, most small and medium businesses are registered as sole proprietorship, meaning that the owner / manager or the entrepreneur is the owner as well as the general manager of his business.

Partnership involves co-ownership of the business by one or a few partners who may be a family member or close friends. Partners may bring their capital or expertise, or both into the business.

A private limited company involves ownership of the business by a limited number of people (usually relatives and close friends) who band themselves for purposes of the business. Ownership is based on shareholding, which can be transferred to other shareholders with the consent of the existing owners.

A public limited company (public corporation) involves many persons owning the business who may not be affiliated with one another. Ownership is determined by shareholding which are floated on the stock exchange and transferable to the public. A corporation has a legal personality and has limited liabilities. A corporation may be managed differently from its owners.

Countries have various regulations regarding the registration of business under each form. It is important that you know them - the relevant laws (e.g., taxation, liability, etc.), the forms to be filled in and the licenses/permits to be acquired (and paid for) before you can legally operate as a business.

3.2 How will the Business be managed and operated?

For the business to operate smoothly and efficiently, there must be certain structures of authority and responsibility (a chain of command), division of labour (job distribution), and definition of what each entity must do in the business (job description). Therefore, the business needs an organisational structure. This is mostly depicted through an organisation chart.

In designing the organisational structure, it is important that the various functions of the enterprise (marketing, production, organisation and management and finance) be performed well. In a small business, one person can handle several functions. For instance, the entrepreneur may 'double up' as general manager as well as production manager.

In small and medium businesses it is also common to have family members holding positions of responsibility in the business or even perform production work. For instance, the wife may be the treasurer and marketing manager, while the older children help out as part-time production workers.

3.3. What are the Business Experiences and Qualifications of the Entrepreneur?

To ensure business survival and growth, it is important that the people who run the business must have the proper qualifications and suitable experience. The survival and growth of the business depends on the competence and ability of management. A class B (medium potential) project managed by a class A (highly competent) manager will mostly turn out to be successful, while a class A project (high potential) run by class C (incompetent) management will fail.

In particular, if the proponent wants to borrow money from the bank or if he wants to get trade credit from his suppliers (raw material, machinery), he must be able to convince them about his ability, competence and integrity.

Therefore, it is of utmost importance that the proponent includes the highlights of his bio data as well as that of the other key officers involved in the business and being relevant to business operations.

If possible, the proponent should include bank references, former employers, or well-known and respected community leaders who can vouch for his integrity as well as his abilities.

3.4 What pre-operating Activities must be undertaken before the Business can operate?

Before the business can start actual operations there are many preparatory steps that have to be carried out. The entrepreneur must be aware of these and plan their execution, so that costs, time and energy can be saved.

A few of these preparatory activities include attendance in a training program (whether skill-related, management or entrepreneurship), preparing your business plan, doing market survey, making trips to machinery and raw material suppliers, registering the business, hiring a consultant, etc.

It is advisable that the proponent lists down all these pre-operating activities and decides when and how long each activity will last. A few of these activities can be carried out simultaneously (e.g., drawing up market survey and contacting suppliers), while others have to be done sequentially (purchasing the machinery before their delivery and installation in the factory).

To aid the proponent he can prepare a Gantt chart, which depicts in one column all these pre-operating activities and a further illustrating the timetable (in weeks, preferably) when each activity will start and be completed.

3.5 What pre-operating Expenses will be incurred?

Pre-operating expenses are those expenses which are needed in order to plan and to prepare for the business operation. These include worker training, market surveys, testing, travel to source suppliers of raw material and machinery or to negotiate with potential market outlets, etc.

In a few cases, you may be able to find workers who do not need any training, but in many cases some form of training is required. As an owner / manager you should have a good idea of the manufacturing process. You may have acquired this knowledge and skill from your previous work, business experience or training. Or this may require that you spend some time in another factory of similar size for exposure and gaining of experience. In most cases, it makes sense to hire at least one good technician who is familiar with the process and who can give on-the-job training to the workers below him. However, this will take some time and as we all know, time is money. Therefore, these costs should be estimated. It may be necessary, for instance, to pay workers a stipend during their on-the-job training before they start full production on a piece rate basis. These pre-operating costs have to be accounted for as part of the total project costs (project's total capital requirement).

3.6 What fixed Assets will be required for the Office?

Aside from the fixed capital needed to manufacture the products or to facilitate and maintain production operation, the business needs other fixed assets to maintain the administrative aspects of the business.

These assets include a typewriter, furniture and fixtures, cabinets, electric fans, calculator, computer, vehicle, etc. These fixed assets also have to be depreciated according to their useful life.

3.7 What administrative Costs will be incurred?

To support production and marketing activities of the business a few administrative activities have to be performed and costs have to be incurred in the performance of these activities. For this reason, administrative costs are also termed operating expenses.

Administrative costs include the salary of the office secretary, bookkeeper, driver, security guard, depreciation of fixed assets, furniture and fixtures used in the office, communications, etc.

Financial Plan

4.1 What is the total Capital Requirement?

Total capital requirement, also known as total project costs or total investment requirement is composed of three items: fixed assets, pre-operating expenses and working capital.

Fixed assets is the sum total of all costs of land and improvements, building, machinery, furniture and fixtures, vehicles, etc. (step 2.2)

Pre-operating expenses are those necessary expenses that are incurred before the business starts operating. These include registration fees and licenses, training costs, costs of preparing the business plan, trips to raw material and equipment suppliers, etc. (step 3.5)

Working capital is the amount of money permanently needed in cash or in kind to keep the business operating while it is awaiting full payment for goods sold to customers.

Working capital can be calculated by adding five factors:

- 1) The costs of maximum raw material stocks that will have to be stored to ensure continuous production. In a few cases this may be three to six months worth, if the raw material is difficult to obtain or has to be imported, whereas in other cases (where raw materials are readily available) only one or two weeks worth may be needed;
- 2) The costs of finished goods kept in stock and awaiting distribution to the customers;
- 3) The costs of a work-in-process that is on factory floor, but have not yet been converted into a final product or finished goods;
- 4) The costs of goods already distributed to customers, but have not yet been paid (accounts receivable);
- 5) The amount of ready cash needed to pay workers and overheads.
 - To determine the costs of raw material stocks, simply multiply the quantity needed by its purchase price;
 - To determine the costs of finished goods stock, multiply the number of units to be kept by the unit production costs (step 2.18)
 - To determine the costs of the work-in-process, first estimate the number of days it takes to convert the raw material into finished goods, then multiply this by the daily production level (step 2.6), thereafter multiply the figure obtained by the unit production costs determined in (step 2.18), and finally divide this figure by 2.

- To determine the costs of goods already distributed, but not yet paid for, estimate the quantity that will be given on credit and multiply this number by the unit production costs (step 2.18)
- To determine the amount of cash needed in the business, add the monthly labour costs in step 2.14 and overheads (step 2.17) to the monthly marketing expenses (step 1.12) and the administrative expenses (step 3.7)

Add these five cost elements together to arrive at the total working capital requirement. To calculate the total capital requirement, add the following:

- + Fixed Assets (step 2.2, step 3.6)
- + Pre-Operating Expenses (step 3.5)
- + Working capital (step 4.1)
- = Total Capital Requirement (Project Costs)

4.2 Is a Loan needed? What will the Equity Contribution of the Entrepreneur be? And if so, how much?

Sourcing of total capital requirement can also be termed the financing plan. Bankers want to know these sources and what different project cost components are being funded by these various financial sources. After determining the total capital requirement, the next step is to see whether the amount required is too much for you to finance on your own, or beyond your capability to finance. If this is the case, then a loan will be needed.

The entrepreneur is almost always expected to make an equity (owner's capital) contribution to the project. For example, if the project costs LC50,000, the bank may require the entrepreneur to put up at least LC10,000, or 20%. The LC10,000 constitutes the owner's equity.

To arrive at the amount of the loan needed, subtract the equity from the total capital requirement. List these as follows:

Source	Amount	Use
Equity	LC 27,000	Working Capital
Loan	LC 70,020	Machinery
Capital Requirement	LC 97,020	

* LC stands for local currency

It is also possible to borrow from other sources like family members, friends, raw material and equipment suppliers, in addition to banks. Hence, your financing plan (although given here in a very simplified manner) may look like the above plan.

4.3 What Security (Collateral) can be given to the Bank?

In addition to equity the bank will demand to know what kind of security the entrepreneur can offer the bank to ensure that the loan is really repayable and repaid. Normally, land and building (the title of ownership has to be certified by the appropriate government authority) are used for security purposes. Be aware that if your building or house is valued by the bank at LC100,000, the bank may only accept 60% of its full value, or LC60,000, for security purposes.

In many countries titled land has a collateral value from 80 to 100%. Likewise, the machinery, vehicles or building which will finance the loan can also be used as collateral. For example, machinery and equipment have a collateral value of 60% of its purchase costs in many countries.

Some credit institutions, especially those catering to small loans, accept personal property (e.g., jewellery, private car, refrigerator, sewing machine, etc.) as collateral.

If the entrepreneur does not have enough security to cover the loan needed, he must then raise this security from friends and relatives or reduce the size of his project until the loan size matches the security requirements of the bank.

4.4 What is the Loan Repayment Schedule?

Prepare the Loan Repayment Schedule. An example is given below. For a loan of LC120,000 at the cost of 10% for six years, the repayment schedule is shown in the table below:

Year	Amount of Principal Outstanding	Instalment due	Interest Payable at 10%	Total Amount
1	120,000	20,000	12,000	32,000
2	100,000	20,000	10,000	30,000
3	80,000	20,000	8,000	28,000
4	60,000	20,000	6,000	26,000
5	40,000	20,000	4,000	24,000
6	20,000	20,000	2,000	22,000
	Total	120,000	42,000	162,000

4.5 What does the Profit and Loss Statement indicate?

We now have all the data needed for preparing a profit and loss statement, also known as the income statement.

Start with sales which are derived from multiplying the unit selling price by the volume of expected sales during the year (step 1.9). From the annual sales revenue figure, step-by-step, subtract all the yearly expenses.

They are as follows:

Profit and Loss Statement (one year)		LC
Sales: 120 kg per day x 20 days per month x 12 months x LC14, or unit selling price (step 1.9)		403,200
Less:		
Raw Material: LC26,070 x 12 months (step 2.11)	- 312,840	
Labour: LC1,600 x 12 months (step 2.14)	-19,200	
Overheads: LC2,333 x 12 months (step 2.17)	- 27,996	- 360,036
Gross Profit		43,164
Less:		
Marketing (step 1.12) & Administrative Costs (step 3.7) (LC50 + 500 x 12 months)	- 6,600	
Operating Profit		36,564
Less:		
Interest Expense (step 4.6)		-7,002
Net Profit before Tax		29,562

- 1) Raw Material Costs: This is the sum of all raw materials used to produce the products that were sold.
- 2) Labour Costs: This is the sum of all direct labour costs for the whole year.
- 3) Factory Overhead Expenses: This is the sum of all miscellaneous costs such as minor raw materials, indirect labour, maintenance and repair costs, depreciation of production machinery, electricity, water, supplies, etc. that are associated in producing the product throughout the whole year.

The three items above are known as Costs of Goods Sold. Sales minus these three items results in Gross Profit.

- 4) Marketing Costs: This is the sum of all selling and promotional costs, including distribution costs to retail shops, commissions, etc.
- 5) Administrative Costs: This is the sum of all administrative costs, including office supplies, security guard salaries, accountant/ bookkeeper's salaries, telephone bills, entertainment expenses, and the depreciation of office equipment and furniture, etc.

Gross profit less marketing/administrative costs results in Operating Profit.

- 6) Financial Costs: This is the sum of interest paid to banks on the amount of borrowing.

Operating Profit less financial costs results in Net Profit Before Tax. Net Profit Before Tax less the relevant business income tax results in Net Profit After Tax. If you are borrowing money from the bank, the latter would usu-

ally require you to project your profit and loss statement (and other figures) corresponding to the life of the loan. That is, if you intend to pay the loan within a span of five years, the bank will ask you to project your figures (e.g., sales forecast, profit and loss statement, cash flow statement, balance sheet, loan repayment schedule, etc.) for five years.

Determination of Selling Price and Profit Margin

Item	Monthly Costs
Raw Material	26,070
Direct Labour	1,600
Overhead Expenses	2,333
Total Monthly Production Costs	<u>30,003</u>
Marketing and Administrative Costs	550
Interest	583.50
Total Monthly Product Costs	<u>31,136.50</u>

Unit Product Costs	120 kg x 20 days
Total Costs per kg	LC12.97
Profit Mark Up per kg (8%)	LC 1.03
Factory Selling Price	LC14.00

4.6 What does the Cash Flow Statement indicate?

In this part of the business plan, the Cash Flow Statement is calculated and included. While the profit and loss statement gives the results of financial transactions of a business during a certain period (e.g. month or year), the cash flow statement shows the sources (inflows) and applications (outflows) of the cash in the business throughout the year.

Cash Flow Statement (example)

Item	0	1	
	Real	Forecast	Real
1. Initial Cash	90,000	35,000	
2. Inflows:			
2.1 Sales	0	22,000	
2.2 Others	0	0	
2. Total Inflows	0	22,000	
3. Outflows:			
3.1 Dividends	0	8,000	
3.2 Labour costs	0	12,000	
3.3 Promotion material	1,500	1,500	
3.4 Rent	19,000	6,500	
3.5 Energy	0	1,000	
3.6 Telephone	6,000	1,000	
3.7 Publicity/Promotion	10,000	0	
3.8 Registration fee	3,000	0	
3.9 Others (Insurance...)	0	0	
3. Total Outflows	55,000	30,000	
4. Net Flow Return (2-3)	-55,000	-8,000	
5. Final Cash Flow (1+4)	35,000	27,000	

NB: The cash flow projection goes up to the end of the business life.

4.7 What does the Balance Sheet indicate?

The balance sheet is the statement of assets and liabilities and provides the financial picture of the business on a certain date, for example, at the end of the year.

Balance Sheet as at the end of the first year	
Assets	LC (local currency)
Current Assets:	
- Cash	23,354
- Raw materials (RM) Inventory	26,070
- Work-in-Process (WP) Inventory	750
- Finished Goods (FG) Inventory	15,000
- Accounts receivable	16,800
Total Current Assets	81,974
Fixed Assets:	
- Land	4,000
- Building	20,000
- Machinery + Equipment	9,000
- Office Equipment	1,000
- Less: Accumulated Depreciation	- 3,400
Net Fixed Assets	30,600
Other Assets:	
Pre-operating Expenses	-
Total Assets	112,574
Liabilities	
Current Liabilities:	
Accounts payable	-
Loans payable	4,004
Total current Liabilities	4,004
Long-term Liabilities:	
Loans payable	52,008
Total Liabilities	56,012
Owner's Equity:	
Beginning Capital	27,000
Add: Net Profit after Tax	29,562
Less: Withdrawal/Dividends	-
Total Owner's Equity	56,562
Total Liabilities and Equity	112,574

4.8 What is the Break-even Point (BEP)?

Three kinds of break-even points (BEP) are commonly referred to, namely:

- 1) BEP Sales (LC)
- 2) BEP Production (volume)
- 3) BEP Percentage (%)

a) Break-even Point (BEP) Sales

Break-even point (BEP) Sales - is that amount of sales value at which no profit or loss is incurred by the business.

b) Break-even Point (BEP) Production

The Break-even point (BEP) Production - is that level (volume or quantity) of production at which no profit or no loss is incurred on the part of the business. Production above this level will result in a profit and production below this point will result in a loss.

c) Break-even Point (BEP) Percentage

Break-even point (BEP) Percentage - is that percentage level of sales or production at which the business neither makes a profit nor loss. Production above this level will result in a profit and production below this point will result in a loss.

To determine the BEP, three figures need to be calculated.

These are:

Sales: annual sales as documented in the profit and loss statement (step 4.4).

Variable Costs - these are the costs that change significantly according to levels of production, and usually consist of raw material costs plus direct labour (step 4.4), provided it is hired and terminated according to the high level of production a factory is making.

Fixed Costs - these are costs such as indirect labour and overhead expenses (steps 2.17 and 3.7), interest and depreciation. These costs do not change significantly, if the factory produces more or less.

Break-even Point (BEP) Calculation

a. BEP Sales

To determine BEP Annual Sales, multiply annual sales found in the income statement by the annual fixed costs and divide by annual sales less annual variable costs:

$$\text{BEP (Sales)} = \frac{\text{Annual Sales} \times \text{Annual Fixed Costs}}{\text{Annual Sales} - \text{Annual Variable Costs}}$$

b. BEP Production

To determine BEP Production Volume, divide BEP Sales by the Unit Selling Price (USP):

$$\text{BEP Production} = \frac{\text{Break-even Point Sales}}{\text{Unit Selling Price}}$$

A further method is to: Divide Annual Fixed Costs by the Unit Selling Price less Unit Variable Costs, also known as Contribution Margin, that is, the remainder of what is left to cover fixed costs and profit. At BEP, the contribution margin can only cover fixed costs, not profit:

$$\text{BEP Production} = \frac{\text{Annual Fixed Costs}}{\text{Unit Selling Price} - \text{Unit Variable Costs}}$$

c. BEP Percentage

To determine the BEP Percentage on yearly sales, multiply the yearly fixed costs by 100, divided by annual sales minus the variable costs.

$$\text{BEP Percentage} = \frac{\text{Annual Fixed Costs} \times 100\%}{\text{Annual Sales} - \text{Annual Variable Costs}}$$

4.9 What is the Return on Investment (ROI)?

One important issue that should be looked into when deciding on whether or not to go ahead with your business is to answer this crucial question: "Will my money be better off in this business or safe at the bank, where it can earn a fixed interest in long-term bonds, savings or time-based depos-

its?" To answer this question, calculate the project's return on investment (ROI), presenting one of the means of measuring profitability.

This is done by dividing Net Profit (step 4.4) by the total capital requirement times 100 (step 4.1): It is more advisable to use Net Profit after Tax, if this is applicable.

$$\text{Return on Investment} = \frac{\text{Net Profit}}{\text{Total Equity}} \times 100$$

A variation in the profitability measure is the Return on Owner's Investments (ROI). This is derived by dividing Net Profit before Taxes by the Owner's Equity (Capital or Investment) times 100, as shown below:

$$\text{Return on Owner's Investment} = \frac{\text{Net Profit}}{\text{Owner's capital}} \times 100$$

If the percentage is greater than the bank's rate on long-term deposits, including allowances for the country's inflation rate during the same period, then the project appears to be financially viable. If it is below the bank rate, then you may consider several alternatives which could include measures, such as increasing the level of production (provided the market is sufficient), looking for ways to reduce costs, or even abandoning the project altogether.

4.10 Is the Project feasible?

Now that all questions related to the four aspects of the business project - that is, marketing, technical, organisation and finance - have been answered, a conclusion should be made on the feasibility of starting the business. Is the profit on the first year sufficient enough to meet the loan and interest repayments? Can marketing or raw material supply problems be overcome? What will happen to project profitability, if raw material costs increase by 10%? What if, the sales forecast is only 80% realised? Any further outstanding questions should be dealt with in this last section.

You also have to decide for yourself whether the expected profit to make is worth all the risks you are taking by starting the business.

Likewise, in addition to ROI which is one of the measures of profitability, other kinds of financial analysis can be carried out to provide a better picture of the business.

These include:

1) Measures of liquidity (e.g., current ratio)

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

A ratio of 2 to 1 has often been considered to be desirable. This rule of thumb, however, is not necessarily valid in all cases and is industry dependent.

2) Measures of solvency (e.g., debt-equity ratio)

$$\text{Debt-Equity Ratio} = \frac{\text{Total Debts}}{\text{Total Equity}}$$

This ratio is very useful to creditors. A low debt-equity will be considered favourable by creditors, as it indicates the business is mostly funded by the owners themselves.

Another financial tool which is required by some banks is the Sensitivity Analysis, which entails subjecting the effects on production costs, profitability, margins, etc. by the changes of certain important inputs, such as raw material prices or labour costs increasing by a certain percentage, let us say 5 or 10%.

For more details refer to the publication
on “Accounting and Cost Calculation”
of the same editor

Business Plan Checklist

Executive Summary

- A. What is the nature of the project?
- B. What are the entrepreneur's competencies and qualifications?
- C. What are the project's contributions to the local and national economy?

Sales and Marketing

- 1.1 What is the product?
- 1.2 How does it compare in quality and price with its competitors?
- 1.3 Where will the business be located?
- 1.4 Which geographical regions will be covered by the project?
- 1.5 Within the market area, to whom will the business sell its products?
- 1.6 Is it possible to estimate how much of the product is currently being sold?
- 1.7 What share or percent of this market can be captured by the business?
- 1.8 What is the selling price of the product?
- 1.9 How much of the product will be sold?
- 1.10 What promotional measures will be used to sell the product?
- 1.11 What marketing strategy is needed to ensure that sales forecasts are achieved?
- 1.12 How much do you need to promote and distribute your product?

Production

- 2.1 How is the production process characterised?
- 2.2 What buildings and machinery (fixed assets) are needed and what will their costs be?
- 2.3 What is the useful life span of the building and machinery?
- 2.4 How will maintenance be carried out and are spare parts available locally?
- 2.5 When and where can the machinery be obtained?
- 2.6 How much capacity will be used?
- 2.7 What are the plans for using spare capacity?
- 2.8 When and how will the machinery be paid for?
- 2.9 Where will the factory be located and how will the factory be arranged?
- 2.10 How much raw material is required?
- 2.11 How much will the raw material cost?
- 2.12 What are the sources of raw material? Are they available throughout the year?

- 2.13 How much direct and indirect labour is needed and which skills should they have?
- 2.14 What will be the costs of labour?
- 2.15 Are workers available throughout the year? If not, what effect will this have on production?
- 2.16 How will the workers be motivated?
- 2.17 What factory overhead expenses are involved?
- 2.18 What are the production costs per unit?

Organisation and Management

- 3.1 How will the business be organised?
- 3.2 How will the business be managed and operated?
- 3.3 What is the business experience and qualifications of the entrepreneur?
- 3.4 What pre-operating activities must be undertaken before the business can operate?
- 3.5 What pre-operating expenses will be incurred?
- 3.6 What fixed assets will be required for the office?
- 3.7 What administrative costs will be incurred?

Financial Plan

- 4.1 What is the total capital requirement?
- 4.2 Is a loan needed? What will be the equity contribution of the entrepreneur? And how high will it be?
- 4.3 What security (collateral) can be given to the bank?
- 4.4 What does the Profit and Loss Statement indicate?
- 4.5 What does the Cash Flow Statement indicate?
- 4.6 What does the Balance Sheet indicate?
- 4.7 What is the loan repayment schedule?
- 4.8 What is the break-even point (BEP)?
- 4.9 What is the return on investment (ROI)?
- 4.10 Is the project feasible?

For more details refer to the publication
on “Accounting and Cost Calculation”
of the same editor

Ethiopian Business Development Services Network (EBDSN)

List of Publications for Business Development

Start and Improve your Business

Identification of viable business ideas, market and supply analysis, write a business plan, organize business management, evaluate sales, improve and diversify products.

Marketing Strategies for Micro, Small and Medium Enterprises

Marketing problems faced by Ethiopian businesses, marketing strategies, managing prices, product development and promotion.

Trade Fair Participation and Export Guide

Trade Fair participation, export procedures, export business registration and licensing, Ethiopian trade statistics, quality export products information.

Business Planning

Business planning for micro, small and medium enterprises: personal data, equipment owned and to be purchased, work premises at the disposal of the operator, production/service plan, raw material requirement, yearly sales plan, operating expenses, profit and loss statement.

Accounting and Cost Calculation Manual

Manual and electronic cash book formats, records on maintenance services, receipt, sales on credit, raw material inventory, cash flow statement, accounting software and software providers in Ethiopia, cost calculation, identify cost components, calculate variable and fixed costs, calculate total cost per unit, how cost calculating improves your business.

Loan Conditions of Commercial Banks and Micro-Finance Institutions

Loan conditions in Ethiopia: loan types, loan term, lending rate, re-payment schedule, type of collateral, loan criteria, eligibility.

Improve your Business Association

Needs assessment of your members, situation analysis, action planning, services, fundraising, membership fees and accounting.

Standards and Quality in Ethiopia

How are Ethiopian standards developed, conformity assessment, testing, product certification, metrology.

Investment Guide

Business environment, investment opportunities and conditions, taxation and incentives, investment protection.

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