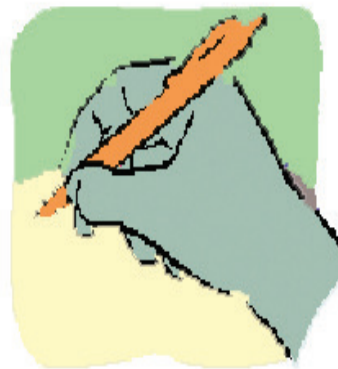




# 5 Business plan

## Introduction

Small and medium scale businesses take an important part in the economy of every country all over the world. The situation is same in Sri Lanka too. Most of the large scale businesses have developed from the small and medium scale businesses in many countries including Sri Lanka.



In most of the countries, including Sri Lanka there is a tendency of closing up of most of the small and medium size businesses within a short period of time after commencement.

The primary reason for this trend is lack of a vision on the business. The vision of the business can be defined as the future position which the company /the business expects to achieve in the long run: This requires a perfect business plan. Without good a business plan it is impossible for any business to survive in the market in the long run.

The vital information about production, human resources, marketing and financial resources would be revealed through the business plan. Objective of this chapter is to explain the details of the above factors which are essential for the preparation of business plans and to give an outline of the business plan to provide skills of preparing a business plan as a first step, of a business idea.

## Need for a business plan

### Concept of business plan

A business plan means a detailed report that is prepared including the objectives and goals and how they are to be achieved.

Business plan can be used as guidance and a correct path to accomplish goals and objectives efficiently. Business environment changes day-by-day. An entrepreneur has to focus his attention to the facts such as the scarcity of resources, rapidly changing technology, entering of new competitors into the market and changes of taste of consumers etc, so that he can face the challenges successfully.

A business plan would answer the following questions.

- ★ Where are we at present?
- ★ Where do we want to go?
- ★ How are we going to get there?

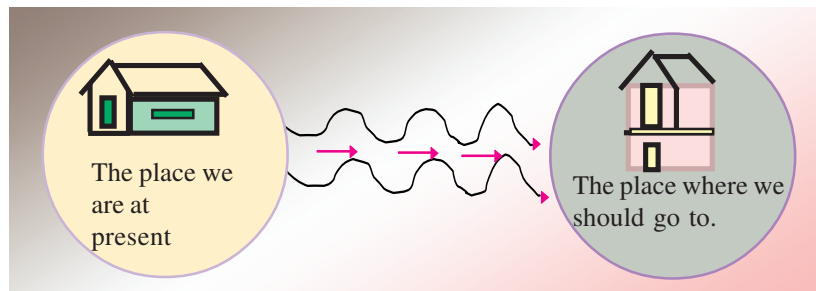


Diagram 5.1

It is highly important to prepare a business plan when a new business venture is started or when an existing business is expanded.

The competency of making a business plan would give a person a valuable opportunity to engage in a any job successfully and to improve the standard of his living through conducting a successful business.

### Importance of a business plan

It is very essential to prepare a business plan for a business. The importance of a business plan can be explained in the following way, using the following diagram.

It would,

- \* explain the vision and mission of the business
- \* guide the organization to achieve the aims and objectives.
- \* assist the organization to improve the strength and remove the weaknesses.
- \* help to obtain the financial allocations.
- \* help to attract employees
- \* help to identify potential problems and give solutions in advance.
- \* help to measure the performance of the business
- \* guide the business to action
- \* motivate the managers as well as employees.
- \* help the stakeholders to build up a favourable image about the business

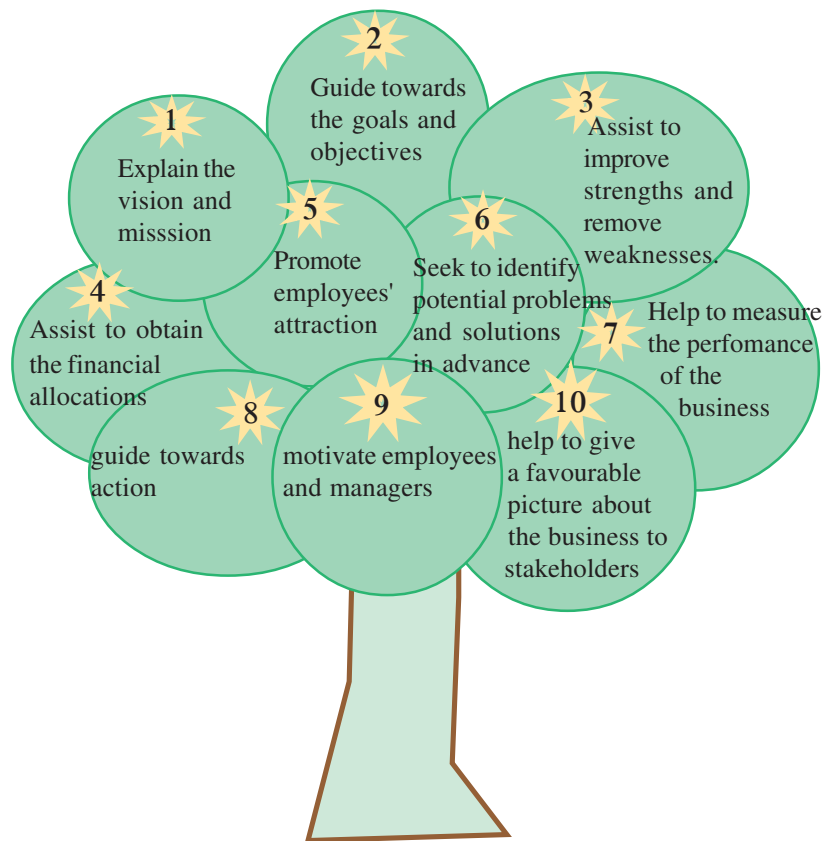


Diagram 5.2

Let us discuss each of the above points

## **Vision and mission**

Vision can be defined as the philosophical view of the future of the business. Vision shows what would be the future position of a person or a business organization. This depicts a whole picture of the expectations of the entrepreneur and where the business is heading to.

Mission explains how the business can achieve its vision (Mission statement)

### **A guide to achieve the aims and objectives**

(Aims are expected long term achievements of an organization. Objectives are the short term achievements)

Aims are the end results of a business which are expected to be achieved in the long run and the objectives are the end results which are expected to be achieved in the short run. Showing aims and objectives in writing in a business plan would motivate the management and the employees to achieve them. It would give a guidance to carry out the activities.

### **Improve the strengths and avoid weaknesses**

Business plan gives an entrepreneur the opportunity to improve the strengths further and avoid weaknesses.

### **Assist to obtain financial assistance**

Business plan shows the amount of financial requirement, when it is needed and how it could be financed. This would help the business to acquire more money when the capital invested by the owner is not sufficient. Most financial institutions require the applicant to submit the business plan along with the loan application. The reason for this is that the business plan is a unit to measure the ability of the business to repay the loan. Therefore, business plan is a good yardstick to measure the ability of repayment of the business.

### **Assist to attract employees**

A business plan explains clearly the success of the business in the future. So, employees would be attracted through the business plan.

### **Ability to identify the potential problems in advance**

Preparation of a business plan would give room to identify the future risks and issues of the business in advance. So, preparations can be made properly against such difficulties and problems can be solved successfully.

### **Measure the performance of the business**

Business plan can be used as a barometer to measure the achievement of goals and objectives or how far the business has achieved them. Success and failure of the business can be recognized so.

### **Guide the business operations**

Business plan is very helpful to verify and ascertain whether the operational activities at each stage are carried out properly and resources are utilized efficiently.

### **Motivate**

Business plan motivates the employees to carry out the activities according to a plan by which the business is expected to achieve its objectives.

### **Favourable mindset**

Business plan helps to create a favourable mindset about the business among the stake holders of the business. For example, it would help the investors to take good investment decisions and also help customers to deal with the business smoothly.

## **A model of a business plan**

Entrepreneurs carry out various types of business activities. Some of them are short term and others are long term. Therefore, it is difficult to produce a common model of a business plan. Nevertheless, any business plan would contain production plan, marketing plan, organizational plan, and financial plan.

Commonly used items in a business plan would be:-

1. Executive summary
2. Description of the business
3. Market Analysis
4. Marketing plan
5. Production and operational plan
6. Human resource plan
7. Detailed financial plan
8. Premises and equipment
9. Details on business expansion
10. Annexes



### Activity 01

Identify a successful business in your area. Analyze and list out factors which helped the business to become a success.

### Forward the business idea in brief.

The business idea should be included in the business plan, in brief. Such information which is included in the business plan would differ from business to business. Often a business plan would include the business idea, the product; motivation to select a business idea, consumers, the market, geographical area, competitors, market share and the marketing mix.

### Business idea

A brief explanation should be given about the business idea which a businessman/entrepreneur is going to start. Vision and the mission of the entrepreneur, the product he is going to produce etc. should be clearly explained here.

### Product

It is necessary to include the details of the product. The information regarding the product would be revealed by answering the following questions:

- \* What is the product or service to be produced?
- \* What are the benefits that can be obtained by consumption of that product?
- \* How or in what way the particular product would differ from other similar products in the market?

### Motivation to select a business idea

The factors which compelled or motivated the entrepreneur to select the business idea should be mentioned briefly in the business plan. Mentioned below are some factors which would motivate to select a business idea.

- \* Skills possessed by the entrepreneur with regard to the business idea.
- \* Connections with market
- \* Family environment and human power
- \* Available resources
- \* business environment and market trends

- \* Technical skills and benefits of educational attainments.
- \* Entrepreneurial education
- \* Exemplary entrepreneurial personalities.

## The consumer

Brief introduction of the business should contain the details about consumers. This would include the following details.

- \* Who are the target customers with regard to the expected business idea?
- \* How would the consumers consume or buy the goods and services?
- \* What do they expect from consumption of such products?
- \* What are the consumption and purchasing patterns of consumers?
- \* How would the consumers show interest in the quality of the goods?

## The market

The following details about the market should be given briefly in the introduction . Answers for the following questions should be included in the summary of the business plan.

- \* What is the market relevant to the product of the business?
- \* What are the factors which led the business to select the particular market?
- \* How far is it possible for the business to sell the goods and services in the existing market?
- \* How can the business supply according to the requirement of the market?
- \* Is there any room for market expansion (diversification?)

## Geographical area

Business introduction should contain the details as the answers for the following questions.

- \* Does the entrepreneur distribute his products?
- \* Does he limit the distribution to a particular area only?
- \* Does he expect to expand the distribution area?

## Competitors

Business introduction should contain the answers to the following questions.

- \* Who are the competitors of the business?
- \* What are the positions of their businesses in the market?
- \* What market segment do they possess?
- \* What are the strengths and weaknesses of the competitors?
- \* What are the strategies to be followed to face the challenges?

## Market segment

Details should be contained about segmented market which is segmented by age structure, income level, gender, lifestyle, and geographical area

## Marketing mix

Marketing strategies should be decided after a careful and comprehensive understanding of the market. The introduction should contain the details on the marketing mix of the business such as the product, price, place, distribution and the promotion.

## Legal status

Legal obligations and legal requirements with regard to the business should be explained here. Registration of business and licence to be obtained should be dealt under this topic.

## Production plan

Procedures for the whole organization deciding on machineries, raw-materials needed for production process of a particular business is known as production plan. When preparing of the production plan, operational information should mentioned briefly such as, production processes, production methods, technology to be used, plant layout, equipment and raw-materials, stocks, warehousing and labour and quality control.

Let us consider above operational information in brief.



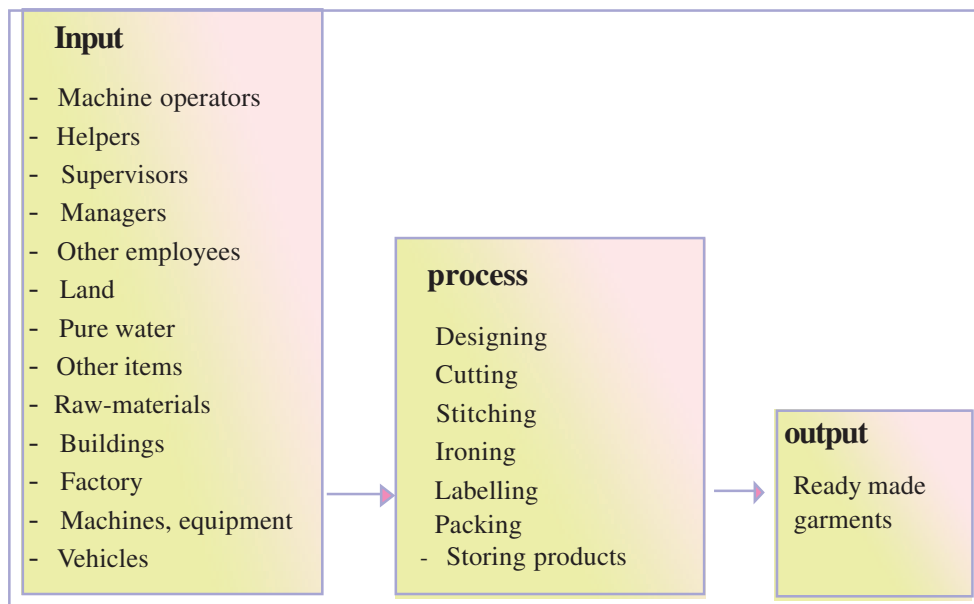
## Production process

The activity of changing raw-materials (input) into finished goods (output) is known as the production process. Inputs are used for production. Production process relevant to the production should be mentioned in the business plan. An example for the production process of manufacturing garment is given below.



Diagram 5.3

### Production process of a garment factory



## Production methods

Production is organized in different methods. Details of production method should be mentioned in brief in the production plan. Production methods can be one of the following.

- \* Job production
- \* Batch production
- \* Flow production (line production)

### Job production

Production of an item is done on an order of customers. This is called job production.

Stitching of dresses, construction of a house, hair cut, food catering requirements for special occasions are some of the examples for job production.

Planning and controlling of production process would be carried out as per the instructions of the person who places the order.

### Batch production

Main feature of batch production is to produce a unit of a product or a number of units of such product at a time according to consumer demand.

Batch production stands between the job production and the flow production.

*Example :* Baking of bread Production of costumes for a band, Production of tables and chairs for a school, Catering services

Here, when the entrepreneur plans the product, he has to consider about changing of resources he uses from batch to batch, as the goods are produced according to the needs of the customers.

### Flow production

Producing a particular item on a continuous basis for the purpose of supplying to the market is known as flow production.

Here, the out put would be prodeceed based on pre-determined specifications.

*Example :* Soap, biscuits, soft drinks, radio, TV and motor vehicles

An entrepreneur can make his production plan selecting the best production method from various production methods mentioned above.

### Technology

Special focus should be given to technology to be used in production process when production plan is prepared. Improvement of efficiency, reducing wastage, improvement of quality of the product, creation of pleasant environment and development of communication would be the end results of using the new technology. Information regarding the technology used by the entrepreneur in his own production should be mentioned briefly in his production plan.

## Plant layout

Plant layout refers to the activities with regard to the production such as location of factory, and placement of machines and equipment. Description of plant lay out should be explained in detail when production planning is done. Plant location and fixing of machines and tools should be mentioned.



diagram5.4

## Raw-materials and equipment

Details of the raw-materials and equipment which are to be used according to the nature of product to be produced should be mentioned in the production plan. Some of such details are as follows.

- \* The raw-materials required for the production
- \* The sources from which the raw-materials are acquired
- \* Tools and equipment required for the production.

## Labour or human resource

Details of the required manpower, type of labour (skilled/unskilled, trained/untrained) recruitment and selection policy, and training methods should be mentioned in the production plan.

Human resource requirement for the first year and how it advances at the future development stages should be mentioned clearly. Requirement of managerial and non-managerial manpower should be identified when the manpower plan is done.



Diagram 5.5

## Stocks and warehousing

The place where stocks are kept until they are used or sold is known as warehouse. Any amount of goods kept for business purpose is called stocks. Following items would be kept as stocks in production activities.



Diagram 5.4

- \* Raw materials
- \* Work-in-progress goods  
(goods that have not yet completed the process of production)
- \* finished goods

When preparing the production plan, the information about stocks and maintenance of the stocks should be started briefly.

## Quality control

All the activities which are undertaken by the producer to protect the quality of the product required and fulfil the consumer needs and wants are known as quality control. The details of the activities to maintain the quality of all products which are expected from a product should be mentioned clearly in the production plan.

There are alternative ways for business to maintain the high quality of the product. Some of them are mentioned below:-

- \* Obtaining 'SLS' certification  
SLS certification is a way of ensuring that a particular product has been manufactured according to the standards set by the Sri Lanka Standards Institution. This mark 'SLS' is mentioned on the label of the product.
- \* Follow the international standards (ISO 9000 series.)
- \* Carry out the production activities as per the standards introduced by the international standard organizations.
- \* International standards on environmental conservation -ISO 14000
- \* Follow the standards on environmental conservation.

## Cost of production

There are plenty of trading as well as manufacturing organizations available. A manufacturing organization is one which manufactures or produces finished goods using raw-materials. Trading organization means an organization which only markets or sells goods and services and not involve in production of such items or services

Main activity of a trading organization is only buying and selling of goods. Manufacturing organization would involve in producing goods using the factors of production. The business has to incur an expense on such factors.

According to this, the value of economic factors which are used to manufacture these items or services is known as cost.

## Cost of production

Expenditure that is incurred to produce products during a certain period of time is called production cost.

Cost of production is an important factor in decision making. Therefore every manufacturing firm calculates the cost of production.

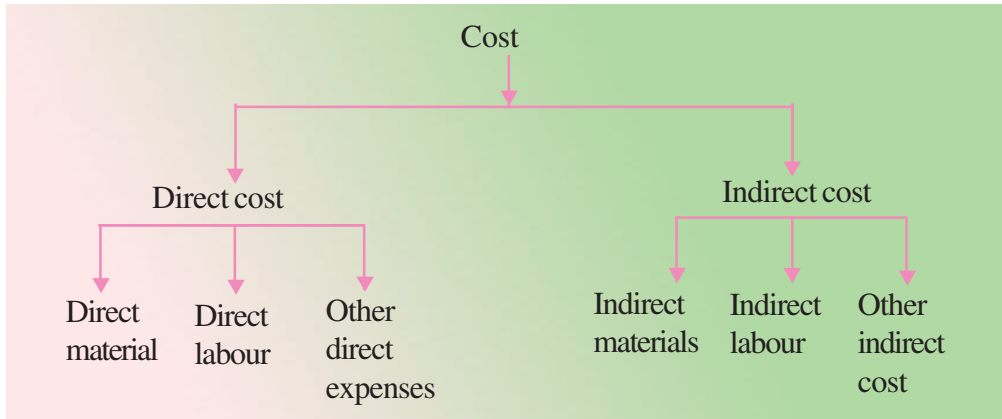
It is necessary for a manufacturing organization to calculate the cost of production due to the following reasons.

- ✳ to find out the total cost of production.
- ✳ to calculate the unit cost
- ✳ to decide the profit margin
- ✳ to fix the unit selling price of the product
- ✳ to control the cost of production

Production cost is classified into direct and indirect cost according to the nature of the cost. It is decided on the basis of whether a particular cost can be charged directly to the production or not.

Direct costs and indirect costs can be classified into several groups. Such groups can be identified by studying the following flow chart.

## Elements of cost



Let us consider each item shown in the diagram

### Direct costs

Direct costs are the costs which can be directly charged to production activities. Elements of direct costs can be classified as follows.

- \* direct material costs
- \* direct labour costs
- \* other direct expenses

### Direct material costs

This is the value of all the physical resources which are actually included in a product.

Example: cost on paper and ink used by a printing press

### Direct labour costs

These are the wages and salaries given to employees who directly involve in the production of an item.

Example: salaries given to employees in the printing press.

### Other direct expenses

These are the expenses other than the direct material cost and direct labour cost on items which are directly used for the production.

Example: Payment of royalty on copyright to the original author

The total of direct material cost, direct labour cost and other direct expenses are known as the prime cost of production

Direct material cost	xx
Direct labour cost	xx
Other direct expenses	xx
Prime cost	<u>xxx</u>

### Indirect costs

The costs which cannot be identified directly with the production are known as indirect costs. These are also known as overhead costs.

According to the basis of indirect cost, it can be classified into the following.

- Indirect material cost
- Indirect labour cost
- Other indirect expenses cost

#### Indirect material cost

The materials which are not directly connected to the production are known as indirect materials. The cost incurred on this is called indirect material cost.

Example : cost on lubrication oil and other tools to maintain the printing machine.

#### Indirect labour cost

The labour cost that cannot be directly connected with the production process is known as indirect labour cost.

Example : wages and salaries paid for supervisors, watchers, and clerical staff.

#### Other indirect expenses

Other expenses which are not directly connected to the production and the costs other than the indirect material and indirect labour costs are known as other indirect costs.

Example : building rent, depreciation of machines, and electricity.

Total of indirect material, indirect labour and other indirect expenses put together we get the cost known as production overhead cost.

Indirect material costs	xxx
Indirect labour costs	xxx
Other indirect expenses	xxx
Production overhead cost	<u>xxx</u>



The entrepreneur can prepare a cost schedule to calculate the cost of production. Following is a model of such a cost schedule.

**Cost schedule**

Direct material	XX	
Direct labour	XX	
Other direct expenses	XX	
Prime cost/ total direct cost		XXX
Indirect material cost	XX	
Indirect labour cost	XX	
Other indirect expenses	XX	
Total indirect costs /production ovehead costs		XXX
Total production cost		XXXX

Unit cost of production can be calculated dividing the total production cost by total number of units produced.

$$\text{Unit cost} = \frac{\text{Total production costs}}{\text{Total output (number of units)}}$$

Example :      Following is the information on of the estimated cost of production of 10,000 copies of a book, for the coming month in a print shop.

	Rs.
Paper and ink	613,200
Wages and salaries of printing employees	180 000
Electricity charges	8,000
Watcher's salary	12,000
Lubrication oil and spare parts	14,000
Supervisors' salary	39,000
Royalty on copyright	300,000
Depreciation of machines	4,800
Building rent	50,000
Machine operators' salary	29,000



Calculate the following items using estimated information given above.

- ★ total direct expenses
- ★ total indirect expenses (production overhead costs)
- ★ total production costs
- ★ unit cost of production of one book printed by the above printing press

### Cost schedule

	Rs.	Rs.
Direct material-paper and ink	613 200	
Direct labour-printing officer's salary	180 000	
Other direct expenses-royalty	300 000	
<b>Total prime cost</b>		<b>1 093 200</b>
Indirect material – lubrication oil and spare parts	14 000	
Indirect labour - watchers' salary	12 000	
Supervisors' salary	39 000	
Machine operator's salary	29 000	
Other indirect expenses - Electricity	8 000	
Machine depreciation	4 800	
Building rent	50 000	
<b>Total indirect cost/total production overhead cost</b>		<b>156 800</b>
<b>Total production cost</b>		<b>1 250 000</b>

i	Total direct cost	=	<u>Rs: 1 093 200</u>
ii	Total indirect cost	=	<u>Rs: 156 800</u>
iii	Total production cost	=	<u>Rs: 1 250 000</u>
iv	Cost of a book	=	$\frac{\text{Total production cost}}{\text{Number of out put (units)}}$
		=	$\frac{1\,250\,000}{10\,000}$
		=	<u>Rs: 125</u>



**Activity 02**

In the given cage state whether the following items of a production firm, are direct costs, or indirect costs.

Firm	cost item)	direct/indirect
(a) a bakery	1). Baker's salary	
	2). Book keeper's salary	
	3). Flour	
	4.) Depreciation of building	
(b)a garment factory	1). Textiles	
	2). Factory rates	
	3). Sewing machine operators' salary	
	4). Maintenance expenses of sewing machines	



### Activity 03

An entrepreneur hopes to manufacture a new variety of arm-chair. Following is the information on estimated cost

Cost of wood	25 000
Carpenters' wages	10 000
Electricity	1 500
Other direct costs	6 000
Carpentry shop rent	5 000
Polish	1 000
Other tools (sandpaper, brushes and nails)	2 500
Supervisors' salary	9 000

- 1) Calculate the total cost of production.
- 2) Calculate the unit cost of a chair with the help of the estimated cost of the chairs if the total number of units to be manufactured is 40.

### Need for of human resources

Employees who serve in a business are called human resource. Human resource is divided into two main groups as managerial and non-managerial employees.

When compared with other resources of a business human resource is an important one. There are many reasons for this. Some of them are

- \* Human resources is a living and active resource
- \* Can think and show resistance
- \* Decision making ability on all other resources
- \* Ability to form groups (trade union activities)
- \* Creative (creativity)

Human resource planning is the process of forecasting the type and number of employees a company will require in the future to accomplish the aims and objectives of the business. There are several advantages for the business of planning human resources in advance. Some of them are:-

- \* Ability to estimate the future manpower requirement
- \* Ability to employ people in various activities efficiently
- \* Can avoid future business breakdowns by forecasting future man power requirements
- \* Can avoid unnecessary costs on recruitment done in an ad-hoc manner
- \* Ability to understand requirements of employee development
- \* Ability to recruit highly skilled persons

Generally human resources plan would contain the following information.

- \* Total man power requirement if an entrepreneur starts his business for the first time (heavily)
- \* Category (managerial/ clerical / technician etc...)
- \* Total numbers of vacancies
- \* Type of employees required (trained/permanent / temporary)

### **Time period for which the human resources is required**

The period in which the human resources is required is different from business to business. If the business has a plan to expand in future it would require more man power.

### **Category of man power required**

This means whether the business needs managerial or clerical staff, labourers or drivers and how many of them are required.

### **Aims objectives and strategies of the business**

If the business hopes to increase the current out put by 50% within the next three years step by step, is a good example for human resource planning on the basis of future requirements on objectives.

### **Production method**

The business has to decide whether it has to increase the labour or capital. If labour is to be increased it is known as labour intensive and it needs a large number of employees. Focus should be given to the government policies and regulations and employment ratio in the country when the external supply is considered

### **Resignations / leaving for good (staff loss)/ and retirement**

How many vacancies would be created due to the above reasons should be estimated clearly.

### **Leave**

How many days of leave no pay leave and leave with pay would be taken is also an important factor.

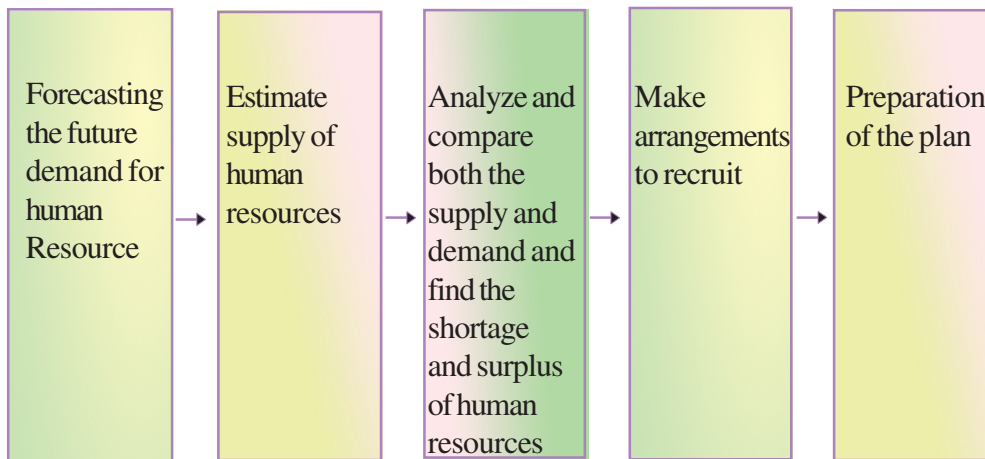
### **External factors**

The external factors such as changes in technologies and legal matters should also be considered as such factors have an impact on employees. The requirement of labour would decrease due to the use of computer technology in the business and that can be given as a good example.

Human resources of a small business would be handled by its owner himself. But it is handled by a human resource manager in a large scale business. A part from that he has a separate department under him known as human resources department.

More over, a business has to follow the following steps when it plans is human resources.

### Process of human resource planning



Above diagram shows how the human resources planning activities would be carried out and it can be explained in the following way.

#### Forecasting the future demand

Here, the factors like the nature of the business, objectives and strategies, production method, retirement, resignation, and leave would be taken into consideration.

#### Estimate the supply of human resources

If it is a business already in operation it has to decide the supply of human resource with in the business (internal supply), promotions are good examples for this type of supply. Nature of the business has a greater impact on deciding the human resources requirement in human resource planning and therefore, following factors should be considered in planning the human resource.

When considering the external manpower supply factors like government rules and regulation and unemployment should be taken into consideration.

For example the human resource requirement should be increased if the demand for the goods or service increases.

### **Analyze demand and supply of manpower and confirm the shortage or surplus.**

This is to see whether there is a shortage or surplus of human resource in each of the departments in the business.

### **Take actions to recruit man power**

It is important for the business to attract and select the suitable and best candidate for the jobs to fill the vacancies, which exist in the business. Attraction refers to motivate suitable people to apply for the vacancies.

There should be a suitable method to select the best from among the attracted applicants. As selection techniques applications interviews, medical test, aptitude test, on the job test, and practical test would be conducted and used to select the suitable and the best person.

Appointing suitable persons to respective jobs is known as recruitment. In case of an existing business organization it has to decide whether recruitment is done internally or externally

### **Preparation of human resource plan**

When a particular business prepares its business plan it has to consider the factors like the post, the job or activity responsibility qualification and the organizational structure etc.

#### **The post/ positions/ status**

A particular business has to consider the relevant posts which are vacant at the time of preparing the plan.

**Example:** post of graphic designer

A post refers to the position or status, legally accepted to perform the duties. Executive status and clerical status can be mentioned as examples.

A job or a post will have the following elements.

- \* Tasks
- \* Duties
- \* Responsibilities

Let us discuss each of them

## Task

A specified piece of work is known as a task.

Duty is identified as the whole work carried out by an employee who has been assigned with many tasks. It can be explained in another way as duty is formed by large number of tasks or works.

## Responsibility

Moral obligation of a person to perform a task or a job perfectly is known as responsibility. Responsibility gives a person the feeling for rights and necessity which also creates the job.

As job description the business would include the details of the tasks of a particular job, duties responsibilities and the working conditions.

## Qualifications

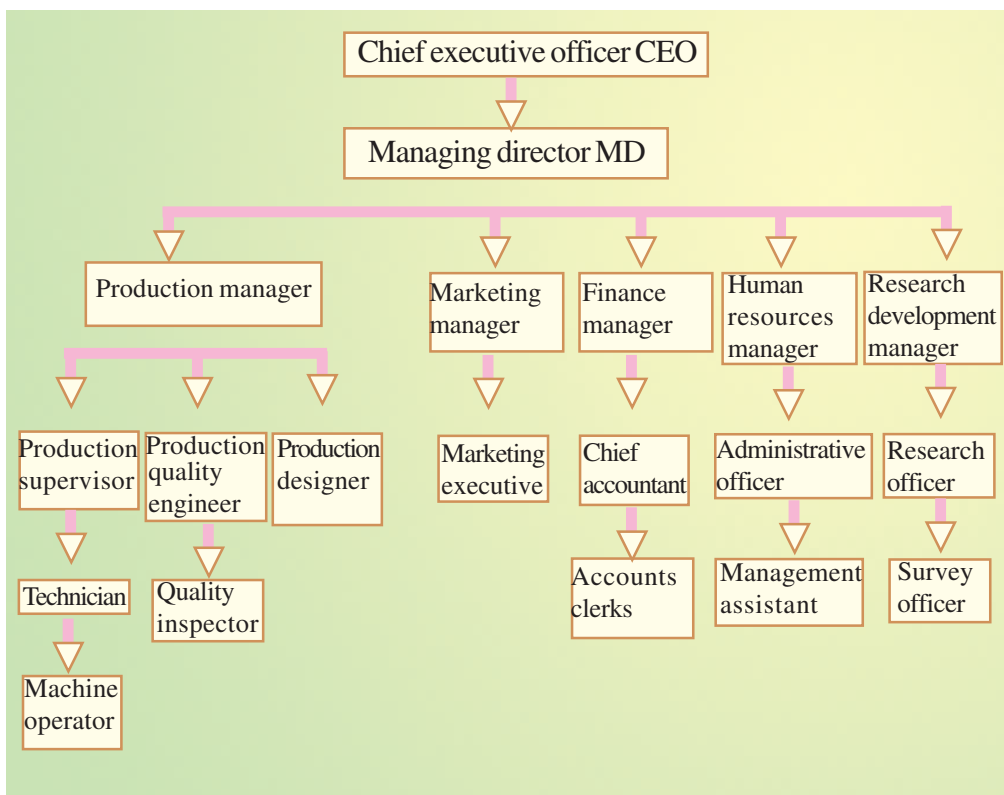
A person in any job must have all the qualifications relevant to that job. The document which contains the qualifications knowledge and skills required for performing a task or to carryout a particular job is called job specification.

Qualifications that are required vary from one job to another. Some of them are as follows.

- \* Educational qualifications
- \* Professional qualifications
- \* Physical qualifications (ability)
- \* Experience in the relevant field
- \* Attitudes and skills
- \* Special talents
- \* Language proficiency
- \* IQ level

## Organizational structure

Organizational structure refers to the inter relationship between various sections and various jobs in a business under which, division of responsibilities and power is mentioned. The organizational structure can be illustrated clearly with a chart and an example for the organizational structure of a medium scale business organization is given below.



**Example** An entrepreneur hopes to modernize his small scale garment factory and convert it into a medium scale in next year. Accordingly, he has planned his human resources requirement as follows.



Employee category	Grade	Human resource demand	Supply of human resource	Required no. of employees
Managers	Executive level	05	05	
	supervisor	06	01	05
	Accountants	01	01	
	production quality engineers	01		01
	production design artist	01		01
	administration officer	01		01
	technician	01		01
	quality inspector	01		01
Non-managerial employees	Management assistant	06	03	03
	clerical staff	07	03	04
	survey subject in charge	01		01
	Machine operators	05	02	03
	trainee labourers	12	06	06
	untrained labourers	16	08	08
	total vacancies exist			35



#### Activity 04

Imagine that you have a special technical ability and talent to make flower vases of a novel design. If you expect to start the business in a small scale and expand the business to distribute your products island wide at the end of the first year, prepare a plan for the requirement of employees for the beginning and for the coming year.

### Initial fixed capital

This refers to the long term assets which are required by the business when the business is started. The cost incurred on such resources is called investment.

An entrepreneur has to focus correctly when he obtains initial fixed capital for the business. Following factors would influence the collection of such capital.

- \* Initial investment on fixed capital is comparatively large
- \* Impossible to make changes quickly in investment on fixed assets.
- \* It is a source of generating long term income for the business
- \* Cost of maintenance of fixed assets is a huge amount.
- \* Fixed assets are one of the main factors which determine the quality of the items produced by the business.

Following are some of the assets which come under fixed capital items.

- \* Land
- \* Building
- \* Machine
- \* Equipment
- \* Motor vehicles

Let us consider each of the above items.

## Land

Land has to be acquired according to the nature and the size of the business that is to be started. Acquiring of land can be through purchase or on lease basis. And also the land has to be developed so that it can be utilized for the purpose.

## Building

Building should be a suitable place for

- \* Operating a factory
- \* Operating an office for the business
- \* To store raw materials and finished products
- \* To keep all other equipments safely

Building can be constructed or taken on lease basis so as to suit the business activity to be started.

## Machinery

Machineries are essential items for business. Type of machines would vary according to the nature and the scale of production. Special attention should be paid to the quality standards of machines when such machines are bought as it is necessary to have high quality standard machines.

## Tools and spare parts

Various types of tools and spare parts are required in trading, production and administration actions.

- Example
- \* various tools/equipment required for production process
  - \* office equipment
  - \* fixtures and office items

## Motor vehicles

Motor vehicles are required to the business for the following purposes:

- \* To bring raw-materials required to the business
- \* To transport the goods produced to the warehouses and to the market.

Estimation of initial fixed capital should be done correctly. Other wise, it would be very difficult to achieve the expected objectives.

Let us estimate the initial fixed capital, with an example related to a product.

**Product -** A set of products which contain one printed bed sheet for infants and four pillowcases  
 Quantity to be supplied - 100 units- twice a week  
 Labour requirements - 10 trained employees  
 10 untrained employees

### Estimate of initial fixed capital requirement

Fixed capital item	quantity	unit value Rs	total value Rs
1) 40 perch plot of land	01	2 000 000	2 000 000
2) buildings with 20'×20' rooms	02	175 000	350 000
3) Store room (20×20)	01	175 000	175 000
4)Sewing machines	04	30 000	120 000
5) Medium size vehicle	01	2 200 000	2 200 000
6) Furniture chairs	10	500	5 000
Tables	05	2 000	10 000
<b>Total estimated cost</b>			<b>4 860 000</b>



### Activity 05

Imagine that you hope to make and market flower pots of special kind. Assume that you possess the technical know-how required

A plot of land is required for the purpose of the construction of the building to carry out the business and for other purposes.

A cost has to be incurred on the purchase of spare parts and tools for making pots and office fixtures.

A vehicle has to be bought for the purpose of purchasing and delivery of raw materials and pots to the market.

Decide the suitable business size and estimate the initial fixed capital.

### Working capital requirement for the business to commence

The necessity of working capital is to be considered by the business because it is required to make the capital items which have to be obtained and ready for the operation. The working capital means, the necessary funds required for the day to day operations. These funds help the business to spend on day to day activities during a short period of time.

There are several factors which influence the requirement of working capital. Some of them are as follows.

- \* Nature of business
- \* Size of the business
- \* Financial policy of the business
- \* The way how the production is done.
- \* Demand level for the product/the market
- \* Amount of loan capital of the business
- \* Facility and chances to obtain loans
- \* Conditions laid by the suppliers
- \* Current trends

Sufficient working capital must be available as it decides the success and continuity of operations of the business. The disadvantages of non-availability of sufficient working capital is that it would be difficult to carryout its day-to-day activities (operational activities). Unable to obtain the raw materials from the suppliers due to the suppliers not being paid in time are some of the problems a business has to face and if might cause the business to go bankrupt. Reasons why working capital is required can be classified in to two.

- ✳ Cost of personnel (members of staff)
- ✳ Cost of operations

Let us consider each

### Cost of personnel (members of staff)

Activities performed by the employees of an organization or business contribute immensely towards the success of that business. There are assistants or helpers even in small businesses. Members of staff of a business consist of managerial and non-managerial personal. Cost incurred on them in a business can be grouped into the following two categories.

- ✳ Direct cost on the members of the staff
- ✳ Cost of training of the staff

#### Direct cost on the members of the staff

Recruitment of employees should be done according to the nature and size of the business. Cost of personnel includes all the expenses incurred from the recruitment to the leaving of such employees from the business. Some examples for such expenses are,

- ✳ Expenses on passing the information to the suitable people with regard to the vacancies that exist. (Cost of advertisement on mass media)
- ✳ Expenses on the selection of suitable employees. Written tests, interviews and aptitude tests can be used for this purpose
- ✳ Payment of salaries and allowances to the employees recruited.
- ✳ Expenses on employee welfare medical facilities, uniforms, refreshment, and transport etc.
- ✳ The government or statutory requirements
  - Employment Provident fund (E.P.F)
  - Employment Trust fund (E.T.F)

## Cost of training of employees.

Requirements of employees vary according to the nature of the business. So the employees should be recruited as

- \* Trained and
- \* Untrained employees

Nevertheless, employees should be trained according to the nature of the task they have to perform so that they would become efficient. Training can be done according to the following ways.

- \* Attach the employees to a specialized institution the training
- \* Provide them on the job training or in-service training

Business environment changes constantly. Employees need training as the tools, spare parts and the technology also change as a result of constant changes in the business environment. Quality aspect of the production activities can also be improved by training. Therefore, a business must have a staff training budget (a plan on cost of training) or an estimate of cost of training

A comprehensive and an efficient method with a series of tasks can be prepared at a low cost by looking for various methods of staff training.

## Cost of operations

Expenses incurred in the course of carrying out the day-to-day business activities are known as cost of operations.

This cost of operation would differ according to the nature of the business, as follows

A manufacturing business – acquisition of raw materials

A mercantile business – acquisition of mercantile material and finished goods

A service providing business – as per the service renders

Even though certain operational costs differ as classified above there exist some common operational costs in respect of each business.

Payment of salaries for employees is an example.

Payment of various bills

- \* Electricity
- \* Water tariff
- \* Telephone

Unexpected situations like:

- \* Non receipt of ordered raw-materials
- \* Leasing an electric generator due to disconnection of electric supply
- \* Destruction of stocks at the stores due to a natural disaster

When a business idea is to be implemented by starting a business, working capital requirement should be estimated in advance. It can be explained by an example.

Let us consider how Mrs. Rasadika has estimated the working capital requirement for her business idea.

Making printed fabric for infant bed sheets and pillow cases.  
One set consists of a bed sheet and four pillow cases.

### Estimate of initial working capital requirement

<u>Cost of personnel</u>		Number of employee	Employees salary Rs	Total salary Rs
Trained		08	6 000	48 000
Untrained		04	4 000	16 000
<u>Operational cost</u>		Qty	unit price	Value Rs.
Textiles		1000 m	34	34 000
Thread		160 reals	10	1 600
Colouring		12 tubes	100	1 200
Brushes		10	40	400
Electricity				1 700
Water				200
Other				1 900
				41 000
				105 000



#### Activity 06

Prepare of a report on working capital requirement for a month's  
Production activity – sewing printed pillow cases

To supply 100 pillow cases once a fortnight (every two weeks)  
to the market is expected.

Number of employees 20

Required raw-materials would be bought once a month.

Market price at present should be considered.

This can be used for another production activity too. Prepare reports by grouping the students into several groups.

The model mentioned below can be used.

Estimate of initial working capital requirement				
Details		owners' inputs	bank loan	total
Fixed (capital) assets				
Land				
Building				
Machines and equipment				
Motor vehicles				
Other fixed assets				
Utilities- obtain electricity, water connections				
Sub total				
Expenditure (before operating)				
Registration of the business				
For planning the buildings				
Others				
Sub total				
Working capital (for a month)				
Raw-materials				
Transport, wages and salaries				
Electricity				
Water				
Postage and telephones				
Building rent				
stationeries				
Sub total				
Total				



## Sources of finance for initial capital

### Introduction

Initial capital helps to integrate (interconnect) all the departments of an organization. The main question or challenge an entrepreneur faces is whether he can obtain a sufficient flow of finance or sufficient capital at the beginning and in the courses of business activities. An entrepreneur or a business has to consider the following types of capital.

- ★ Initial capital
- ★ Working capital
- ★ Capital for development purposes

Structure of capital should be formed according to the requirement, and the business can achieve more success through that.

### Sources of initial capital

The amount of capital requirement at the beginning of a business varies according to the nature and the size of the business. But the proper knowledge and understanding of the sources of capital is vital before starting a business as it is not possible to start a business without funds.

Sources of capital can be divided into two.

- ✧ Equity capital (owners' capital)
- ✧ Loan capital

### Equity capital (owners' capital)

Equity capital refers to the capital invested by the owners. Success or the failure of the business is determined by the creative talents of the owners. The owners have to face loss of capital, if the business fails.

Accordingly, the business has no responsibility of payment of the owner's capital back. It has to be considered as a benefit to the business. Financial experts say that half of the initial capital should be provided by the owners.

**Equity capital can be obtained from the following sources.**

- Personal savings
- Family members, friends and close relatives
- Partners
- Private investors

Let us consider one by one.

## Personal savings

This refers to the savings a person makes out of his total income after the expenditure on consumption. Any entrepreneur would first focus his attention towards his personal savings. If his personal saving is adequate to start the business he would not look for other sources.

## Close relatives

If the personal savings is not sufficient to start a business, attention is directed to other sources or options. Main focus here is to look for close relatives and friends to obtain the funds. They would come forward to invest on the basis of the trustworthiness and the ability of the entrepreneur. When compared with other sources, relatives and friends would wait patiently with the business during its journey of success. In other words these parties would not give the entrepreneur unnecessary pressure to obtain their money back. However, there are some disadvantages also attached to these sources. Let us consider them here after.

Even the close relationship would shatter if the business fails due to some or other reasons or carelessness. Therefore the entrepreneur has to enlighten them of the business risks involved, when he generates the funds from these sources.

## Partners

This can be said as one of the main sources of capital or finance used to generate equity capital very often.

Those who have money would be taken as partners and the capital required would be collected from them. This method can be used and a considerable amount of capital can be generated from this source. It is an advantage. But there are some disadvantages also. Other partners would also propose their ideas when a decision is taken. Therefore the independence of the entrepreneur would be lost. Apart from that the profit of the business also would have to be shared among the partners.

## Private investors

Investors are the persons who would contribute their money to a business in anticipation of earning a profit. Investors hope to commit their money saved in a production or profitable way. These investors invest their money for various reasons.

- ★ To earn a higher return
- ★ Satisfaction of being connected with an efficient business
- ★ A social need of a connection with the business community.

An entrepreneur has not only the chance of generating more capital using above mentioned sources but also the chance of working with people who have good managerial skills.

## Loan capital

Funds obtained from any party on the basis of a loan is called loan capital. If the funds obtained from the sources mentioned above are not sufficient, an entrepreneur can generate funds from loans. An interest has to be paid on the funds obtained and so the loan has to be repaid at maturity. Therefore lenders who provide loan capital would look at the performance of the business. They would not give funds to those businesses which have a tendency of failure.

Following are some of the methods from which a loan can be obtained.

- \* Trade credit
- \* Equipment credit
- \* Monetary credit
- \* Mortgage loan

Let us consider each of them.

### Trade credit

This means that goods required can be obtained from the suppliers on credit basis. Obtaining raw materials from the producers and the finished goods from traders all on credit basis are good examples for this.

Sometimes suppliers would lay down some conditions on the supply of such materials on credit basis. If the creditors make the payments on time suppliers would give discounts to them. That means that the suppliers would deduct a percentage from the due amount. This is known as discount. The advantage of this system is that the person who obtains the goods on credit can settle the payment only after the sale and receipt of money. The business can give the cash to the supplier from the cash received as a result of the sale of such goods.

### Equipment credit

This means to obtain machines and spare parts of a capital nature on credit basis. Most of the businesses will not have sufficient funds at the beginning. If such businesses have to buy those capital items for cash, they will have to face a liquidity or cash problem. Therefore this type of credit is crucial at the beginning and thereafter. An initial payment has to be made and the balance of the price can be settled in installments.

Example: Value of a machine is Rs. 75,000. Initial payment is Rs. 7,500.  
The business can use the machine after the initial payment of Rs. 7,500.

The advantage here is the opportunity for the business to use the machine without making the full payment. It is the duty of the entrepreneur to earn a sufficient income from the business as he has to pay the installments.

### **Cash credit/ monetary loan**

This is the method of obtaining money on the agreement of repayment of cash so obtained with interest, within a given or agreed period. Traders have to repay debts and other outstanding amount to various parties from whom they have obtained cash and goods at the beginning and while the business is going on. They have to collect money from formal and informal financial institutions and other sources. A trader has to fulfil such obligations, like interest payments and due payment on time, which lenders have laid down.

These loans can be classified into long term loans and short term loans. Short term loans mean loans with the maturity (repayment period) of less than one year.

Following financial institutions lend short term and long term loans.

- \* Commercial banks
- \* Finance companies
- \* Licenced specialized banks
- \* SANASA bank
- \* State and non governmental financial institutions

### **Mortgage loans**

A business can obtain a long-term loan from a financial institution; say a bank, against a security of an immovable property. This loan is known as mortgage loan. The amount which can be received is less than the value of the property which is given as the security. A higher interest rate would be charged. Lenders of this kind exist in rural areas as well as in cities; they may be individual lenders or lending institutions. Loan can be obtained under this method very easily and quickly rather than obtaining from a formal institution.

Owners' capital input and debt financing

Source of funds (capital)	Advantages	Disadvantages
Equity capital Personal Savings	<ul style="list-style-type: none"> <li>• All the profits can be taken</li> <li>• Less amount of loans</li> <li>• Carry out the activities efficiently as incurring a loss is risky</li> <li>• Ability to build up a confidence in lenders and suppliers.</li> </ul>	<ul style="list-style-type: none"> <li>• Possible to incur losses</li> <li>• Possibility of giving a pressure for a personal responsibility</li> <li>• Profit would be less due to the use of the savings of other investors.</li> </ul>
Friends and relatives or family members	<ul style="list-style-type: none"> <li>• Larger amount can be collected.</li> <li>• Ability to collect a large amount of loans.</li> <li>• Share the losses / risks among them.</li> </ul>	<ul style="list-style-type: none"> <li>• Possibility of giving up a part of the profit.</li> <li>• Giving up a part of ownership</li> </ul>
From a partnership	<ul style="list-style-type: none"> <li>• Easy source of collecting capital</li> <li>• Reduce tension and pressure</li> </ul>	<ul style="list-style-type: none"> <li>• possibility of a risk of losing personal connection</li> <li>• Increase of unnecessary intervention.</li> </ul>
From a limited company	<ul style="list-style-type: none"> <li>• Ability to raise a very large amount of capital</li> <li>• Share the financial risks</li> <li>• Less statutory indebtedness and liabilities</li> <li>• Saving on tax payable</li> </ul>	<ul style="list-style-type: none"> <li>• Possibility to give up a part of the profit</li> <li>• Losing control of the business party</li> </ul>
work with financial institutions.	<ul style="list-style-type: none"> <li>• Helping small business</li> <li>• Easy to obtain funds</li> </ul>	<ul style="list-style-type: none"> <li>• Like to diversify the business.</li> </ul>

Source of funds	Advantages	Disadvantages
Obtain funds from all sources.	<ul style="list-style-type: none"> <li>• Comparatively easy to obtain</li> <li>• Ability to control and manage the business</li> <li>• Ability to repay during the most favourable times</li> <li>• Ability to save money</li> <li>• Ability to deduct the tax payable from expenses</li> <li>• Ability to repay from the profit during the times of inflation.</li> </ul>	<ul style="list-style-type: none"> <li>• high interest expenses</li> <li>• risk of non payment from the future profit</li> <li>• inefficient use of funds</li> <li>• possibility of sharing the financial information</li> <li>• influences of lenders</li> </ul>

### Activity 07



You have got some amount of money saved. Your elder brother is ready to help you in conducting a business. A bank has come forward to provide you with financial assistance as you have submitted a comprehensive business plan.

Prepare a report on initial capital structure with sources and amount you obtain from each.

### Activity 08



You have an amount of money you saved. Two of your friends have given their consents to help you. If the machineries required are bought for cash you have to face cash difficulties in buying other assets and fulfil other requirements. A friendly trader has agreed to supply raw materials on credit with 2 months credit period. The branch of the ..... bank in your area has agreed to give you Rs..... maximum as a loan.

Prepare a report based on this information on initial capital formation with the amounts.

## Preparation of monthly sales budget

The main objective of any business activity is to earn a profit. The profit would vary according to the nature of the business.

- Examples
- If it is a manufacturing organization it would supply its products to customers.
  - If it is a trading organization it would supply the finished goods to customers according to the demand
  - If it is a service providing organization it would render services required by the customers.

Each one of the above can be treated as an opportunity of sales.

The difference between the budgeted and actual sales should be found to measure the success of a business. Following factors should be considered when the sales are estimated.

- \* The quantity
- \* The price
- \* The turnover

Let us consider each of them

### 01 quantity/ units

Quantitative nature of the sales is called quantity. Sales would be done on the basis of units. Accordingly the budgeted quantity of sales is the number of units expected to sell during a particular period. This unit would be described in different terms. Some examples are given below.

In a trading organization product/sales items	unit
Vegetables	gram
Spices	gram
Fish	gram
Meat	gram
Mineral oil	litre
Land	hectare

In a manufacturing business sales items/product	unit
Bread /eggs	loaf/single unit
Uniform	one set
Furniture	one table /desk

Service providing organization service rendered	unit
Hair dressing	per person
Repair	per vehicle

## Price

Amount of money charged for a product or service is called the price.

Price would be expressed in different ways.

Example	✦ hair cutting - charge
	✦ Tutorial class - fees
	✦ labour - salary or wages

The amount of money exchanged by the customers who receive goods or service is known as price. An entrepreneur has determined the price in an intelligent way because he has to attract the customers as well as to exist in the market for a long period. Pricing of a product will affect both of the things. A business of whatever the nature has to consider various factors in pricing their products.

Those factors are as follows.

- ✦ Cost of the product
- ✦ Demand for the product
- ✦ Competitors' price

Price of the goods would be expressed in the following way.

Potatoes 01 kilogram	Rs 40/=
01 litre of milk	Rs 45/=
01 meter of cloth	Rs 60/=
Hairdressing per person	Rs 75/=
To stitch a shirt	Rs 125/=

## Turnover

Turnover is calculated by multiplying the quantity of products sold by the unit selling price.

$$\text{Total number of units sold} \times \text{unit price} = \text{total turnover}$$



Following are the examples of budgeted sales of two businesses.

Sales budget (estimate) of a furniture manufacturer

Item	quantity				unit Price Rs.	turnover Rs.	Total value Rs.
	1 <sup>st</sup> week	2 <sup>nd</sup> week	3 <sup>rd</sup> week	4 <sup>th</sup> week			
Desk	10	10	10	10	6 000	240 000	320 000
Chair	50	50	50	50	400	80 000	

Sales budget (estimate) of a business which distributes packets condensed of milk

Period	type	quantity litres	price per litre	turnover
Jan.	plain	300	40	12 000
	vanilla flavoured	100	45	4 500
	Chocolate flavoured	100	50	5 000
Feb.	plain	300	40	12 000
	Vanilla flavoured	150	45	6 750
	Chocolate flavoured	150	50	7 500



### Activity 09

Imagine that you are an entrepreneur who market flower vases made of clay, of different sizes and different colours. Prepare a sales budget (estimate) for the month of April.



### Activity 10

Prepare a monthly sales budget of a service organization.

## Preparation of fund flow statement for the future (cash flow forecast)

This is the statement or report of inflow and outflow of funds during a particular period, known as fund flow statement or cash flow forecast.

This cash flow statement is prepared for an upcoming period of one year or half a year. According to this, the report of estimation of expected income of the period and the expenditure of that period is known as the cash flow statement.

The cash flow statement so prepared would reveal the date or period and the level of cash expected to receive and the period when the expenditure should be paid. How much money is required to start the business, whether the cash to be received is sufficient to incur the expenses, which is the period when the income would be low, whether the available cash is sufficient to pay such expenses and such information like whether cash shortage or surplus would be known in advance, with the help of a cash flow statement. Efficient cash management can be carried out in the following ways.

- Identify and make pre arrangements for future cash shortage if any in future.
- Surplus cash can be identified and decisions can be taken to invest that

money in viable investments.

Example: If there is surplus cash in the business necessary machineries can be purchased to diversify the business

### Fund flow

Cash flow statements will have the following two major items.

1. inflow of cash / cash comes to the business
2. outflow of cash / cash goes out

Let us consider them one by one



Diagram 5.7

### Inflow of cash / cash comes in

A business receives cash from various ways and sources during a particular period. The main sources of inflow of cash are from:

- Owners
- Loans
- Sales
- Other

Let us consider them briefly.

### Owners

This is the contribution of cash by the owners. This is known as capital contribution by the owners.

### Loan

This is the cash obtained from outsiders on the agreement of repayment / settlement. An interest has to be paid on this. Loan would be obtained from persons and institutions. The repayment should be done according to the way agreed by the business.

### Sales

This is the cash received from the prime activity of the business. This is the main activity of the business. Therefore special focus should be given in this regard. Cash from cash sales and the cash received from the debtors for whom the goods are sold on credit would be considered here.

### Other receipts

There are other ways the business receives cash. Some businesses would receive cash from other sources rather than from its main activity. Following are the other ways from which the business receives cash.

- \* Building rent received
- \* Interest on money lent
- \* Proceeds from the fixed assets which cannot be used further
- \* Commissions received from the agency functions.

### Out flow of cash /cash goes out

Cash would go out of the business due to purchase of goods and services obtained. Reasons for out flow of cash would differ according to the nature of the business. But, generally cash goes out from all types of businesses due to the following reasons.

- \* Investments
- \* Operational activities (day-to-day activities)
- \* Interest payments
- \* Other

Let us consider each.

## Investments

Durable items should be obtained for the long term existence of the business.

- Example
- ★ Motor vehicles
  - ★ Furniture
  - ★ Machineries

Payment of cash for this purpose is known as investments.

## Operational expenses

This refers to the out flow of cash for day-to-day activities.

- Example
- To purchase raw-materials and other goods, payment of wages and salaries, payment of electricity, insurance, buildings rent and transport

## Interest payments

The business has to pay the interest as per the agreements on loans obtained from the outsiders.

## Other

- Repayments of loans
- Leasing installment

The repayment period of above items should be identified clearly. Following is the fund flow statement of a business for 03 months.

Fund flow statement of Sahan Udawatte's business for the period from the 1<sup>st</sup> of January 2009 to 31<sup>st</sup> of March 2009

	January	February	March
<b>Cash receipts</b>			
Capital	75 000		
Bank loan	15 000		
Sales proceeds	40 000	60 000	75 000
Other income	3 500	4 000	6 200
<b>Total cash receipts</b>	<b>133 500</b>	<b>64 000</b>	<b>81 200</b>
<b>Cash payments</b>			
Raw-materials	24 000	32 000	32 000
Salaries	8 000	9 000	9 000
Selling expenses	4 200	5 000	3 500
Electricity	1 200	1 700	1 700
Loan repayment		1 500	1 500
Instalments	48 000		
	1 500	2 000	2 000
<b>Total cash payments</b>	<b>86 900</b>	<b>51 200</b>	<b>49 700</b>
<b>Net cash surplus / (Shortage)</b>	<b>46 600</b>	<b>12 800</b>	<b>31 500</b>
<b>Balance brought down from previous month</b>		<b>46 600</b>	<b>59 400</b>
<b>Closing balance of cash</b>	<b>46 600</b>	<b>59 400</b>	<b>90 900</b>

Fund flow statements can be prepared for 06 months and 01 year using the model mentioned above.

## Cash in hand

Cash payments have to be made during the day-to-day business activities. Likewise, the business would receive cash from the day-to-day business activities. There will be a remaining cash balance after the deduction of payment over the receipts of cash. This is known as the cash-in-hand. The report prepared at the end of each day or every month to calculate the cash-in-hand is known as the cash book or cash account.

## Preparation of a cash account

(01) To know the remaining cash balance at the end of each day.

Date	transaction	(debit) cash in	(credit) cash out	balance

(02) to know the cash balance at the end of a period

Date	details	cash in	Date	details	cash out

According to the above explanations fund flow statement is the report of inflow and outflow of cash during a particular period of time. Cash book or account is the report only on cash payments and receipts and the cash balance at the end of a particular period.

01) Following is the information on cash receipts and payments of Tharaka Traders

March		Rs.
01	Initial capital put by the owner	75,000
02	Obtained a bank loan	15,000
04	bought a machine for cash	48,000
05	bought goods for cash	24,000
07	payment of insurance premium	5,00
16	salaries paid	8,000
20	paid electricity	1,400
21	sold goods for cash	33,000
23	commission received	1,200

24	drawings (cash)	1,500
27	postal and telephone expenses	6,00
30	selling expenses	6,300
31	building rent	5,000

Cash book to know the daily balance

Date	Transactions	(debit) cash Rs.	(credit) cashRs	Balance Rs.
01	capital invested by the owner	75 000		75 000
02	bank loan	15 000		90 000
04	bought machines		48 000	42 000
05	bought goods		24 000	18 000
07	insurance paid		500	17 500
16	paid salary		8 000	9 500
20	electricity expenses		1 400	8 100
21	goods sold (sales)	33 000		41 100
23	receipt of commission	1 300		42 400
24	drawing		1 500	40 900
27	postal and telephone charge		600	40 300
30	selling expenses		6 300	34 000
30	building rent paid		5 000	29 000
30	closing balance			29 000
	Cash-in-hand			

Cash book to know the cash balance at the end of the period.

Date	Transactions	cash receipts Rs	Date	Transactions	cash payments Rs
01	capital	75 000	04	machines	48 000
02	bank loan	15 000	05	goods	24 000
21	sales	33 000	07	insurance	500
23	commission	1 300	16	salaries	8 000
			20	electricity	1 400
			24	drawing	1 500
			27	postal	600
			30	selling expenses	6 300
			30	building rent	500
			31	cash-in-hand	29 000
		1 24 300			1 24 300
04/01	cash-in-hand	29 000			

### Activity 11



Prepare a fund flow statement for the 06 months from January 2009 to June of the Gama Naguma project.

#### Consider the following

Include 04 entries each for inflow and out flow of funds

Repayment of loan once in every 03 months

A machine has to be bought in the 05<sup>th</sup> month.



### Activity 12

prepare the cash account of Bandula's trade for the month of March and find out the cash-in-hand on the 31st of march.

01	capital by the owner	50,000
02	obtained a loan	10,000
03	bought a machine for the business	15,000
10	paid license fees	4,00
12	paid insurance premium	6,00
14	paid building rent	2,500
17	bought raw-materials and goods	21,000
20	salaries paid	7,000
22	paid electricity	1,700



23	sold goods	32,000
24	repair expenses	4,200
26	drawings for personal use	1,500
28	Postal and telephone charges	1,200
29	transport	8,00

### Estimation of net profit of a business

A profit and loss statement or an income statement is useful to see whether the business is profitable or incurring losses. Following factors should be considered when the estimate of profit or loss is done.

#### Sales

This includes the cash sales and credit sales.

#### Cost of sales

Cost incurred in respect of the goods sold during a particular period is known as cost of the sales.

#### Calculation of cost of sales

Value of the stock of goods at the beginning (opening stock)	xxx
--	-----

#### Add

Value of the goods (stocks) Purchased during the period	xxx
---	-----

#### Less

Value of the stocks of goods at the end of the period (closing stock)	(xx)
Cost of sales	xxx

#### Gross profit

Gross profit is the amount we get by deducting the cost of the sales from the sales revenue.

#### Expenditure / total cost expenditure

These are the expenses a business has to incur in the course of its business activities including the cost of labour and other costs.

### Example

- \* Wages and salaries
- \* Building rent
- \* Insurance
- \* Electricity
- \* Advertisement
- \* Repairs
- \* Postal and telephone charges

### Net profit before tax

Net profit is the amount we get by deducting all the item of expenses from gross profit. From this we can understand how for particular businesses achieve its profit limit or the limit of losses it incurs. This is also known as the profit before tax (PBT).

### Income tax

A business has to fulfil its obligations as per the provisions of National Inland Revenue Act. According to this act the business has to pay income tax to the government. At present, the business has to pay the income tax on its own estimated figures. This is the system which prevails at present. It should be done quarterly or every three months and the business has to pay the tax to the Inland Revenue Department. Hence, the tax would be paid on the basis of self estimation when the profit and loss statement is prepared.

### Profit after tax (PAT)

This is the profit after deducting the estimated tax from the profit before tax.

Denuka Traders supply school uniforms and ties to Kumara Vidyalaya. Following is the statement of profit and loss for the month of January 2009.

**Denuka Traders**  
Estimated Income statements for the month of January 2009 (Rs.)

Turnover		
Cash sales	80 000	
Credits sales	15 000	
Total sales / turnover		95 000
Cost of sales		
Opening stock	14 000	
Purchase	45 000	
	59 000	
Less		
Closing stock	8 000	
Cost of sales		51 000
Gross profit		44 000
Expenses		
Wages and salaries	8 000	
Building rent	3 000	
Electricity	1 400	
Insurance	300	
Postal and telephone	400	
Selling expenses	1 200	
Total expenses		14 300
Profit before tax		29 700
Less		
Estimated tax		4 000
Profit after tax		25 700



### Activity 13

Fill in the blanks with suitable words based on the income statements above.

- I) Cash sales and ..... put together we get the value of the total value of sales.
- II) ..... should be added and the ..... should be deducted from the opening stock to get the cost of the sales.
- III) Gross profit would be calculated by deducting ..... from ..... value.
- IV) Profit before tax would be calculated by deducting ..... from the gross profit
- V) ..... would be calculated by deducting the ..... from profit before tax



### Activity 14

Prepare the income / profit and loss statement of the business of Dilum for the period ended on the 31<sup>st</sup> of March 2009

	Rs.
Stock of goods on the 1 <sup>st</sup> of March	7,500
Purchase of stock of goods	35,000
Cash sales	72,000
Credit sales	15,000
Wages and salaries	4,000
Electricity	1,700
Advertisement	3,000
Building rent	4,000
Other expenses	2,700
Stock of goods on the 31 <sup>st</sup> of March	9,900

Imagine that the estimated tax on profit is 20%

- I) How much is the profit before tax?
- ii) How much is the profit after tax?



### Activity 15

The owner of Lokuge Trades provides you the following details for the month of March 2008

	Rs.
Cash sale	75,000
Credit sales	13,000
Purchases (cash)	3,400
Wages	5,000
Electricity	1,300
Transport expenses	1,200
Advertisement	7,00
Other expenses	9,00
Interest of Loan	1,200
Opening stock of the period	9,500
Closing stock of the period	7,400
Estimated tax	4,500

Prepare the income statement so that the profit before and the profit after tax can be realized.

### Preparation of the Balance sheet of the business

We do not discuss here how to prepare the balance sheet or the contents of the balance sheet that you have already understood.

Following is an example for a balance sheet of a business

Devika Traders  
Balance Sheet as at the 31<sup>st</sup> Dec, 2008

Assets	Rs.	Rs
Current assets	16 000	
Cash	3 000	
Receivables	8 000	
Stocks		27 000
Fixed assets / non current assets	85 000	
Land and buildings	35 000	
Machineries/ equipments		120 000
<b>Total assets</b>		<b>147 000</b>
<b>Liabilities and net assets</b>		
Current liabilities		
Payable (expenses)	3 000	
Tax payable	4 000	
Long term liabilities		7 000
Mortgage Loans	8 000	
Bank Loan	15 000	
<b>Total Liabilities</b>		<b>30 000</b>
<b>Equity (capital / net value)</b>		<b>117 000</b>
		<b>147 000</b>

Focus your attention to the following factors with regard to the above model

- Assets = Liabilities + Net assets
- Net assets = Total assets – total liabilities
- Net assets / net value is known as equity capital



### Activity 16

Following are the details of Gallage Traders for the period ending 15<sup>th</sup> January 2008

	Rs
Value of Machines	80,000
Furniture and Fittings	12,000
Cash in hand	9,500
Receivable	7,000
Mortgage Loans	25,000
Payables (accruals /credits)	4,500
Tax payables	3,000
Stocks	12,500

- a. Calculate the capital of the business
- b. Prepare the balance sheet using an acceptable model



### Activity 17

Methsiri is a fruit seller. Following are the details of his business for the period ending 12<sup>th</sup> March 2008

Land and Building	240,000
Tradable Instrument	20,000
Bank Loan	18,000
Payables (accounts)	3,500
Tax payables	4,500
Cash	19,000
Stocks	14,000
Receivables	8,500

Methsiri requires you to prepare a balance sheet to find his capital (equity)



## Summary

You have so far learnt to prepare a business plan and other related activities to be done to implement a business idea. A business plan shows the different stages of the path to be travelled. A business plan confirms where you are and where you should be.

The only intention of a business plan is not the providing of funds. It is only one objective. Estimation of cost can be done by preparing a production plan through analyzing the business idea in details. Estimation of cost of labour can be done by preparing a human resources plan. Sources of funds can be analyzed through initial capital requirement plan. The understanding of the business would be confirmed through the preparation of plans or budgets in this way.

## A model of a Business Plan

Let us consider how to prepare a business plan with the fictitious names of places and people and numbers.



diagram 5.8

### 1 Summary

Mr. Sandun hopes to make vases of different styles. He hopes to make them and sell in the name of ‘Asiri Flower Vases’ even though there is a lot of competition in the market. He hopes to make them durable and look natural using modern technology.



## 1.1. Business Idea

The promoter of this business Mr. Sandun has followed local and foreign courses in making artificial flower making. He has also participated in artificial flowers exhibitions and received certificates of merits

His objective is to supply artificial flowers for interior decoration of beautiful homes giving priority to consumers' tastes.

He hopes to achieve a 40% profit on the sales at the end of first year and hopes to increase the turnover of unit up to 50% and 100% during second and third year.

## 1.2. Products

Outer cover of the vase is made of plastic. Flowers and leaves are made of cloths and polythene which are meant specifically for this purpose.

Asiri Flower vase can be differentiated from other vases in the market with a special fragrance present in the flowers. Special feature of this product is that the consumer can maintain his interior with a special fragrance all the time. So it can be said that by consuming this product the consumer can experience more utilities than what he pays.

## 1.3. Inducement for the production of this product

The prime reason to choose this product is the childhood dream of marketing flowers vases and that he has followed advance courses in artificial flower making. Also the experience obtained from the production of vases made of cement by his father.

## 1.4. Target market (Market Segment)

The target market of this product consists of all who like to have interior design of very high quality. He hopes to market only in the southern region. It would be extended to other regions as well.

## 1.5. Competitors

Various producers' of flowers are there in the market. It is believed that this particular vase would be easily identified from the competitors' products by the appearance and the special fragrance it has.

## 1.6. Marketing

### 1.6.1. The product

This vase has been made with the help of a special machine using plastic substances.

It is expected to purchase a special variety of cloths and polythene and other materials available in the market for the production. Main features of this product are high level of its finish and durability and one year guarantee. The patent right also would be obtained in future.

### **1.6.2 Pricing**

Pricing would be done with the objective of becoming the market leader. The price would be decided by adding a percentage of profit to the cost of production (Mark up Price). It is decided to fix the price for every vase and to grant discounts or deductions from the list price during the festival seasons.

### **1.6.3 Distributions**

It is hoped to follow the direct marketing distribution method. Mr. Sadun would use his own vehicle that is designed for this purpose, and to distribute the product at special fairs. No need to store large amount of stocks. It is hoped to distribute the product as soon as the product is out.

### **Promotion**

It is hoped to spend much money on advertisement. It is decided to put up a large banner at the market where the marketing is taking place and to conduct a door to door advertising campaign.

## **2. Details of the business**

Mr. Sadun hopes to produce more than 25 varieties of vases.

### **2.1 ownership of the business**

He plans to carryout the business as a sole proprietorship he hopes to register the business as “Asiri Flora Manufacturers”

## 2.2 Initial financial requirement of the business.

Estimated financial requirement schedule

	Rs.	Rs.
Initial fixed Capital		
Land	360 000	
Building	280 000	
Machines	120 000	
Furniture and tools	140 000	
		900 000
Working capital requirement		
Cost of personnel	360 000	
Repayment of loan	210 000	
Other operational costs	340 000	910 000
		1810 000
Sources of funds		
Owners capital	1 200 000	
Long term loan	500 000	
Short term loan	110 000	1 810 000
Capital and the liabilities		1 810 000

## 2.3 Location of the business

He hopes to purchase a land of 40 perches which is close to his home and to construct a building of the size 20' × 20' with two rooms and roof of tin sheets.

## 3. Analysis of the market

Weekly fair of the area would be used to market the "Asiri flower vases". Sadun's three-wheeler which is specially designed to transport the vases would be used for transportation purpose with the assistance of other employees.

It has been decided to use five days of the week for marketing purposes and the remaining two days of every week used for production of the vases. It is proposed to obtain ideas of consumers by conducting a market research.

## 4. Marketing plan

Marketing would be done based on customer concept according to the 'Asiri manufacturers'. Advertisements would be used only for making customers aware and to create a trust in the minds of customers through the advertisement done through the words of mouth. Promotional activities would be carried out during the seasonal times and distribution of goods would be done on a door-to-door basis.

## 5. Production and operational plan

### 5.1 production method

Production would be in small scale in the first year. Services of a supervisor, an experienced person and a labourer would be obtained for this purpose. A special machine would be used for making the vase.

Technological know how of only the owner would be used in the production activities. New technology is used for designing and colouring. They hope to get quality standard certification in future, on this product.

### 5.2 raw-materials

Raw-materials for the production, such as plastic, textiles, polythene, cement, sand, and different colouring substances would be used.

### 5.3 cost of production

In addition to the owners' capital invested annual interest of 10% should be paid on the loans obtained from outside interest on the opening balance of the loan at the beginning of the year has to be paid. Bank loan has to be settled with in five years in equal installments. Additionally depreciation of 10% would be provided on cost of (value) machineries used for the production activities.

It is estimated to pay 15% of income tax on net profit. It is expected to produce 2000 vases in the first year.

(Estimated manufacturing cost schedule)

Production budget would be as follows

	Rs.	Rs.
<u>Cost of raw-materials</u>		
Plastic, textiles, and cement	240 000	
Paint, other materials	80 000	320 000
<u>Cost of labour</u>		
Direct labour cost (direct wages)	120 000	
Supervisors' salary	96 000	
Factory maagers' salary	144 000	360 000
<u>Other factory costs/ pduction costs</u>		
Electricity	18 000	
Insurance	12 000	
Interest on loan	61 000	
Depreciation on machines	12 000	
Other costs (miscellaneous)	17 000	
		120 000
<b>Total production Cost</b>		<b>800 000</b>

**5.4 Pricing and sales forecast/ sales budget**

Mark up pricing method by adding 40% profit to the cost of production, would be followed to fix the price.

Accordingly,

$$\begin{aligned} \text{Unit cost of production} &= \frac{\text{Total production cost}}{\text{Total units produced}} \\ &= \frac{\text{Rs. } 800\,000}{\text{Units } 2\,000} = \underline{\underline{\text{Rs } 400}} \end{aligned}$$

Profit added would be 40% of the cost. Therefore the portion of profit would be

$$= 400 \times \frac{40}{100} = \underline{\underline{\text{Rs. } 160}}$$

Price of a unit would be = Cost + Profit

$$= 400 + 160 = \underline{\underline{\text{Rs. } 560}}$$

All the sales would be on cash. Production, it is hoped to increase relative to the first year by 50% in the second year and 100% in the third year, and sales would also be increased by the same levels. Sales budget would be as follows for that purpose.

	1st year	2nd year	3rd year
Quantity of vases to be produced and sold	2 000	3 000	4 000
Sales income (limit price Rs. 560)	1 120 000	1 680 000	2 240 000
Growth rate in relation to first year	—	50%	100%

## 6. Human resource plan

Human resources requirement would be according to the needs arising from the increase of production and sales in two successive years.

Type of labour	1st year	2nd year	3rd year
*Manager	01	01	01
trained labour	01	01	02
untrained	01	02	03
supervisors	01	01	02
Total labour requirements	04	05	08

The owner himself would function as manager

## 7. Detailed financial plan

### 7.1 fund flow statement

The salary of Rs. 35 for a trained worker and Rs. 25 for an untrained worker would be paid for each flower vase produced. Monthly salary of a supervisor would be Rs. 8000 and salary of the manager is Rs. 12,000 per month.

Flow of fund in the 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, year would be as follows.

### Fund flow statements

	1st year	2nd year	3rd year
<b><u>Receipt of cash</u></b>			
cash sales	1 120 000	1 680 000	2 240 000
total receipts	1 120 000	1 680 000	2 240 000
<b><u>cashre payments</u></b>			
payments of staff salary			
• Direct wages	120 000	255 000	580 000
• Supervisors' salary	96 000	96 000	192 000
• Managers' salary	144 000	144 000	144 000
cost on raw-materials	320 000	480 000	640 000
Electricity	18 000	24 000	30 000
Interest on loan	61 000	40 000	30 000
Insurance	12 000	12 000	12 000
Other production costs	17 000	25 000	32 000
Repayment of short term loans	110 000		
Investment (15% fixed deposits)			800 000
Bank loan repayments	100 000	100 000	100 000
Selling expenditure	45 000	60 000	80 000
Payment of income tax	41 250	79 800	73 200
Total expenditure payment	1 084 250	1 315 800	2 713 200
Net cash receipts	35 750	364 200	(473 200)
Opening cash balance	910 000	945 750	1 309 950
Closing cash balance	945 750	1 309 950	836 750

## 7.2 estimated profit

Estimated profit schedule for the first 3 years would be as follows.

	1st year Rs.	2nd year Rs.	3re year Rs.
Sales	1 120 000	1 680 000	2 240 000
Less-cost of the sales	800 000	1 088 000	1 672 000
Gross profit	320 000	592 000	568 000
<u>Less-other operational expenditure</u>			
Advertising and selling expenditure	45 000	60 000	80 000
Profit before tax	275 000	532 000	488 000
<u>Less- income tax</u>	41 250	79 800	73 200
Net profit after tax	233 750	452 200	414 800

## 7.3 Estimated balance sheet

Budgeted/ estimated balance sheet for the 1<sup>st</sup> year would be as follows. Asiri flower vase manufacturer's balance sheet as at 31-12-2008.

Asiri flower vase menu factories balance sheet as at 31-12-2008

### Asiri flower vase manufacturers balance sheet as at 31.12.2008

	Rs.		Rs.
Capital	1 200 000	Non-current assets	
Add-net profit	233 750	Land	360 000
	1433 750	Building	280 000
Non-current liabilities		Machines	120 000
10% bank loan	400 000	Less-depreciation	12 000
		Furniture and fittings	140 000
Current liabilities			888 000
		Current assets	
		Cash	945 750
	1 833 750		1 833 750



## 8. Plant premises and equipments

“Asiri Flower Vase manufacturers” hopes to purchase a plot of land of 40 perches to conduct the business. There is a plot of land near Sandun’s house which he hopes to purchase and some of the infrastructural facilities such as electricity and transport facilities are available. Proposed building would contain 2 rooms of 20' ×20'. in one of which the machines would be fixed. The other room would be used as the stores where finished or completed vases would be kept. It is hoped to construct another building as the business expands.



### Activity 18

Draw up the balance sheets of “Asiri Flower Vase manufacturers” as at the end of the 2<sup>nd</sup> and 3<sup>rd</sup> year.