COURSE GUIDE

ENT 302
FEASIBILITY AND BUSINESS PLANNING

Course Team

Dr. Abdullahi Araga S. (Course Writer)
Department of Financial Studies
Faculty of Management Sciences
National Open University of Nigeria

Oluremi Oyedokun T. (Course Writer)
Department of Entrepreneurial Studies
Faculty of Management Sciences
National Open University of Nigeria

Oluwatomi Adedeji (Course Writer)
Department of Administration
Faculty of Management Sciences
National Open University of Nigeria

Prof. Emerole Gideon Ahamefula (Course Editor)
Department of Business Administration
Faculty of Management Sciences
Michael Okapara University, Umudike

Dr. Lawal Kamaldeen (H.O.D)
Department of Entrepreneurial Studies
Faculty of Management Sciences
National Open University of Nigeria

Dr. Timothy Ishola (Dean)
Faculty of Management Sciences
National Open University of Nigeria

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
University Village
Plot 91 Cadastral Zone
Nnamdi Azikiwe Expressway
Jabi, Abuja.

Lagos Office
14/16 Ahmadu Bello Way
Victoria Island, Lagos

e-mail: centralinfo@noun.edu.ng
URL: www.noun.edu.ng

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1.0 INTRODUCTION

ENT 302: Feasibilities and Business Planning is a two credit course for students offering B. Sc. Entrepreneurship in the Faculty of Management Sciences.

The course consists of fourteen (17) units, that is, Four (4) modules at Four (4) units for first, second and fourth modules and five units for the module three. The material has been developed to suit Undergraduate students in Entrepreneurship at the National Open University of Nigeria (NOUN) by using an approach that treats fundamental areas of business proposals.

A student who successfully completes the course will surely be in a better position to write and present business proposals for a new venture.

The course guide tells you briefly what the course is about, what course materials you will be using and how you can work your way through these materials. It suggests some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully. It also gives you some guidance on your tutor-marked assignments. Detailed information on tutor-marked assignment is found in the separate assignment file which will be available in due course.

2.0 WHAT YOU WILL LEARN IN THIS COURSE

This course will introduce you to the fundamental aspects of feasibility study and business proposals generally. It also includes Sources of Information for Feasibility Studies, Generating Data for Feasibility Studies, Business Description, Location or Siting of Business, Management and production Unit, Technical Analysis, Defining Management Team for Operation Unit, Market Analysis and Marketing Plan, Defining Marketing Strategies, Business Plan Implementation, Financial Analysis, Financing Plan, Preparing Business Proposals, cash flow analysis, traditional investment appraisal methods, Discounted cash flow Methods of Appraisal and Economic Appraisal and Evaluation.

3.0 COURSE AIMS

The course aims, among others, are to give you an understanding of the intricacies of business proposals and how to write and present business plans for new ventures.

The Course will help you to appreciate Sources of Information for Feasibility

Studies, Generating Data for Feasibility Studies, Business Description, Location or Siting of Business, Technical Analysis, Market Analysis and Marketing Plan, Defining Marketing Strategies, Business Plan Implementation, Financial Analysis, Financing Plan, Preparing Business Proposals, and Writing a Loan Proposal.

The aims of the course will be achieved by:

- Explaining the Concept of feasibility study;
- Identifying sources of and generating data for feasibility study;
- Discussing the aspects of business proposals;
- Presenting the aspects of business plans;
- Highlighting and discussing technical and financial analyses;
- Describing marketing analysis and marketing strategies;
- Discussing implementation of business plans; and
- Explaining how to write and present loan proposals.
- Explaining the traditional investment Appraisal Methods

4.0 COURSE OBJECTIVES

By the end of this course, you should be able to:

- Define the concept of Feasibility Study;
- Discuss the fundamental aspects of Business Proposals;
- Analyse the aspects of Technical and Analyses;
- Discuss the aspects of Marketing Analysis and Strategies;
- Analyse the Implementation of Business Plans;
- Explain preparation of Business Description; and
- Prepare and present Loan Proposals.
- Explain the traditional investment Appraisal Methods

5.0 WORKING THROUGH THIS COURSE

To complete this course, you are required to read all study units, attempt all the tutor- marked assignments and study the principles and approach to preparing business proposals in this material provided by the National Open University of Nigeria (NOUN). You will also need to undertake practical exercises for which you need access to a personal computer running the necessary software that can be used to prepare financial projections. Each unit contains self-assessment exercises, and at certain points during the course, you will be expected to submit assignments. At the end of the course is a final examination. The course should take you about a total 17 weeks to complete. Below are the components of the course, what you have to do, and how you should allocate your time to each unit in order to complete the course successfully on time.

6.0 COURSE MATERIALS

Major components of the course are:

- Course Guide
- Study Units
- Textbooks
- Assignment file

8.0 STUDY UNITS

The study units in this course are as follows:

MODULE 1:

Unit 1: Sources of Information for Feasibility Studies Unit
2: Generating Data for Feasibility Studies
Unit 3: Business Description
Unit 4: Location or Siting of Business

MODULE 2:

Unit 5: Management and Production
Unit 6: Technical Analysis
Unit 7: Defining Management Team for Operation Unit
Unit 8: Market Analysis and Marketing Plan

MODULE 3:

Unit 9: Defining Marketing Strategies Unit 10: Business Plan Implementation
Unit 11: Financial Analysis Unit 12: Financing Plan
Unit 13: Preparing Business Proposals

MODULE 4:

Unit 14: Cash Flow Analysis
Unit 15: Traditional Investment Appraisal Methods
Unit 16: Discounted Cash Flow Methods of Appraisal
Unit 17: Economic Appraisal and Evaluation of Projects

8.0 ASSIGNMENT FILE

In this course, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain for these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in the section on assessment in this course guide. There are 14 tutor-marked assignments in this course; the student should attempt all the 14.

9.0 PRESENTATION SCHEDULE

The presentation schedule included in your course materials gives you the important dates for this year for the completion of tutor-marked assignments (TMAs) and attending tutorials. Remember, you are required to submit all your assignments by the due date. You should guard against falling behind in your work.

10.0 ASSESSMENTS

There are two aspects to the assessment of the course: first are the tutor-marked assignments; and second is a written examination.

In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the ***Presentation Schedule*** and the ***Assignment File***. The work you submit to your tutor will count for 30% of your total course mark.

At the end of the course, you will need to sit for a final written examination of 'three hours' duration. This examination will also count for 70% of your total course mark.

11.0 TUTOR-MARKED ASSIGNMENT (TMAs)

There are fifteen tutor-marked assignments in this course and you are advised to attempt all. Aside from the course material provided, you are advised to read and research widely using other references (under further reading) which will give you a broader viewpoint and may provide a deeper understanding of the subject. Ensure all completed assignments are submitted on schedule before set deadlines. If for any reasons, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Unless in exceptional circumstances extensions may not be granted after the due date for submission of Tutor-Marked Assignments.

12.0 FINAL EXAMINATION AND GRADING

The final examination for this course will be of 'three hours' duration and have a value of 70% of the total course grade. All areas of the course will be assessed and the examination will consist of questions, which reflect the type of self-testing, practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed.

Utilize the time between the conclusion of the last study unit and sitting for the examination to revise the entire course. You may find it useful to review your self- assessment tests, tutor-marked assignments and comments on them before the examination.

13.0 COURSE MARKING SCHEME

The work you submit will count for 30% of your total course mark. At the end of the course, you will be required to sit for a final examination, which will also count for 70% of your total mark.

15.0 TUTORS AND TUTORIALS

There are 14 hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone numbers of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must submit your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion group if you need help.

The following might be circumstances in which you would find help necessary, when:

- you do not understand any part of the study units or the assigned readings.
- you have difficulty with the self-tests or exercises.
- you have a question or problem with an assignment with your tutor's comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participations in discussions.

16.0 SUMMARY

ENT 302: Feasibilities and Business Planning intends to expose the undergraduate students to the nitty-gritty of generating data and preparing feasibility study as well as preparing and presenting business plans and loan proposals, be it in new venture or existing business entities that may need loan facilities for expansion and acquisition. Upon completing the course, you will be equipped with the knowledge required to produce a good business plans and loan proposals.

We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you every success in the Future.

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UNIT 1: SOURCES OF INFORMATION FOR FEASIBILITY STUDIES

CONTENT

1.0 INTRODUCTION

Business is a venture undertaken towards making some profits. Business ventures involve some operations which are characterized by various forms of risk. Therefore, it is always necessary to carry out some assessment of the viability of the business before embarking on it. The process of assessing the viability of a business is the feasibility study. In order to carry out a feasibility study some forms of information are required. Hence the discussion in this first study unit revolves around assessment of business viability and various sources of generating the required information for a feasibility study.

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Explain the meaning of a feasibility study
- Discuss the importance of a feasibility study
- Mention and discuss sources of information for feasibility studies

3.0 MAIN CONTENT

3.1 MEANING OF A FEASIBILITY STUDY

A feasibility study involves the process through which the viability of a business can be assessed. Since it involves a process, steps are taken to analyze the workability and profitability of a proposed business venture. The analysis takes into consideration the following areas of business operations:

- Financial Requirement
- Production Requirement
- Personnel Requirement
- Demand and Supply of Product/services
- Financial Projections

I) Financial Requirements

This involves issues such as:

- Amount of Capital required
- Sources of Funds
- Amount of Working Capital required

II) Production Requirements

This involves issues such as:

- Scale of Operation
- Product and Services of the business
- Proposed Installed Capacity
- Assets and Facilities required

III) Personnel Requirements

This involves issues such as:

- Staff Strength required
- Management Staff
- Specialize Staff
- Contract Staff
- Job Specifications/Delineations

IV) Demand and Supply of Product/services

These involve issues such as:

- Market Potential

- Quantity Supplied:- quantity produced locally and imported
- Demand Schedule
- Possible Market Share of the business

V) Financial Projections

These involve issues such as:

- Pro forma Income Statement
- Pro forma Balance Sheet
- Loan Repayment Schedule
- Interest Payment Schedule
- Operations Expenses Schedule

Self Assessment Exercise

Mention and explain the various aspects of a feasibility study.

3.2 IMPORTANCE OF FEASIBILITY STUDY

The feasibility study is very important in setting up a new business in the following ways:

i) To assess the viability of the new business;
ii) To avoid some operational problems in carrying out the business;
iii) It is a requirement for accessing loan or credit facilities;
iv) It serves as a blueprint for implementation of business plan;
v) It is used to assess the potential business risks and meditative measures;
vi) Portrays the financing requirements for the new business;
vii) To assess the potential demand and markets for the products/services of the new business;
viii) Identifies requirements in areas of personnel and facilities for the business;
ix) Identifies operational costs/expenses in areas of preliminary expenses, working capital, machineries and equipment, sundry facilities; and
x) Identifies potential sources of finance and repayments schedule.

Self Assessment Exercise

What are the advantages of a feasibility study?

3.3 SOURCES OF INFORMATION FOR FEASIBILITY STUDIES

There are various sources through which the required information for a feasibility study can be generated. Such sources of information are identified and discussed below.

1. National Bureau of Statistics
2. National Directorate of Employment
3. Federal Ministry of Trade and Investment
4. State Ministries of Commerce and Industry
5. Commercial Banks
6. Chambers of Commerce
7. Trade Associations
8. Newspapers and Periodicals
9. Libraries
10. Research Institutes
11. Electronic media
12. The Internet

In addition to the foregoing sources, there are other sources such as the Internet, Professional journals, Consultancy Firms, etc.

Self Assessment Exercise 3:

List the various sources of obtaining information for feasibility studies.

4.0 CONCLUSION

You will appreciate the fact that feasibility study is very imperative in assessing the viability of a new business. The discussion above is indicative of the fact that feasibility study is required for a new business because it is needed to put such in a good stead for effective and profitable operations.

Nevertheless, a feasibility study cannot be carried out without the necessary pieces of information. Such forms of information are required for determining aspects of business operations in areas of financial requirement, production requirement, personnel requirement, demand and supply of product/services, and financial projections.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to feasibility study.

- Meaning of a Feasibility Study
- Importance of Feasibility Study
- Sources of Information for Feasibility Studies

In the next study unit, we shall discuss the issue of generating data for feasibility studies.

6.0 TUTOR MARKED ASSIGNMENT

Mention and discuss various considerations in technical analysis.

Solution to Self Assessment Exercises

SAE 1. The various aspects of a feasibility study are as follows:

i) Financial Requirements

This involves issues such as amount of capital required, sources of funds, amount needed for preliminary expenses, etc.

ii) Production Requirements

This involves issues such as scale of operation, product and services of the business, proposed installed capacity, assets and facilities required, etc.

iii) Personnel Requirements

This involves issues such as staff strength required, management staff, specialize staff, contract staff, job specifications/delineations, etc.

iv) Demand and Supply of Product/services

These involve issues such as market potential, quantity supplied:- quantity produced locally and imported, demand schedule, possible market share of the business, etc.

v) Financial Projections

These involve issues such as pro forma income statement, pro forma balance sheet, loan repayment schedule, interest payment schedule, operations expenses schedule, etc.

SAE 2. Advantages of a feasibility study are as follows:

i) To assess the viability of the new business;

ii) To avoid some operational problems in carrying out the business;

iii) It is a requirement for accessing loan or credit facilities;

iv) It serves as a blueprint for implementation of business plan;

v) It is used to assess the potential business risks and meditative measures;

vi) Portrays the financing requirements for the new business;

vii) To assess the potential demand and markets for the products/services of the new business;

viii) Identifies requirements in areas of personnel and facilities for the business;

ix) Identifies operational costs/expenses in areas of preliminary expenses, working capital, machineries and equipment, sundry facilities; and

x) Identifies potential sources of finance and repayments schedule.

SAE 3. The various sources of information for feasibility studies are as follows:

i. National Bureau of Statistics

ii. National Directorate of Employment

iii. Federal Ministry of Trade and Investment iv State Ministries of Commerce and Industry

v. Commercial Banks

vi. Chambers of Commerce

vii. Trade Associations

viii. Newspapers and Periodicals

ix. Libraries

x. Research Institutes

xi. The Internet

xii. Professional journals

xiii. Consultancy Firms

xiv. Electronic media

7.0 REFERENCES/ FURTHER READINGS

Ezeanyagu J.E., (1995), Project Packaging for Business Funding – Methods and Case Studies, Enugu: Precision Printers and Publishers.

Hisrich, R. D. and Peters, M. P. (1998), Entrepreneurship, 4th Ed., Boston: Irwin McGraw-Hill, A Division of The McGraw-Hall Companies.

Imaga, E.U.L. (2003), Groundwork of Project Management and Feasibility Studies, Owerri: Ibeson Press.

Odufalu O. (2000), The Principle and techniques of project Analysis and Evaluation, Lagos: Y2K Academy Ltd.

Sahlman, W. A. (1997), "How to Write a Great Business Plan", Harvard Business Review, July – August.

Aruwa, S. A. S. (2006), The Business Entrepreneur: Entrepreneurial Development, Small and Medium Enterprises, 2nd Edition, Kaduna: Entrepreneurship Academy Publishing.

UNIT 2: GENERATING DATA FOR FEASIBILITY STUDIES

CONTENT

1.0 INTRODUCTION

In the preceding study unit we discussed the realm of feasibility study. The discussion in that unit has an aspect which portrays the sources through which valuable pieces of information can be generated for the feasibility study. However, you will appreciate the fact that information cannot be useful unless and until they are generated for specific aspects of the feasibility study. Hence this is the subject of discussion in this study unit.

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Discuss the information need for a feasibility study
- Explain the information required for marketing
- Mention and discuss various information needs for operations
- Identify and explain three areas of financial information

3.1 INFORMATION NEED FOR A FEASIBILITY STUDY

The preparation of the feasibility preludes the preparation of the business plan. This is because before committing time and energy to preparing a business plan, the entrepreneur should do a quick feasibility prospect of the business concept to see if there are any possible barriers to success. The information, obtainable from many sources, should focus on marketing, finance, and production. The internet can be a valuable resource for the entrepreneur.

In the preparation of the feasibility study, the entrepreneur should clearly define the goals and objectives of the venture. These goals help define what needs to be done and how it will be accomplished. These goals and objective also provide a framework for the business plan, marketing plan, and financial plan. Goals and objective that are too general or that are not feasible make the business plan difficult to control and implement.

Basically the lack of feasible business goals and understanding of how these goals would be achieved can spell a fault start for the entrepreneur. The entrepreneur may need someone who is experienced in business feasibility to assess a business and offer valuable information and advice for the ultimate direction.

Hence the important consideration is that the business plan cannot be taken lightly and that it must reflect reasonable goals. The business plan is needed for the formulation of viable business strategies. These goals, in essence, needed to be translated into specific, successful marketing strategies. The entrepreneur will use his invested capital to focus on his target market and control growth and costs. From this plan, possible losses in the growth stages will be minimized.

Self Assessment Exercise 1:

What are the areas of need for generating information for feasibility study?

3.2 Market Information

One of the initial important elements of information needed by the entrepreneur is the market potential for the product or service. In order to ascertain the size of the potential market, the following basic questions are necessary:

- Is the product most likely to be purchased by men or women?
- Are the consumers people of high income or low income?
- Are they rural or urban dwellers?

- Are they highly educated or less educated people?

A well-defined target market will make it easier for the entrepreneur to ensure viable product market size and subsequent market goals for new venture. To assess the total market potential, the entrepreneur should consider trade association, government report, and publish studies. In some instance, this information is readily available in newspapers, periodicals, magazines, and other publications as well as electronic media.

The entrepreneur should be able to estimate the size of the market from secondary data. The entrepreneur can also contact existing businesses. In the process of contracting a few of such outfits to discuss relevant issues could provide valuable insights for the business plan. From this, the entrepreneur would be able to determine an approximate size of the market.

3.3 Operation Information Needs

The relevance of a feasibility study of the manufacturing operations depends on the nature of the business. Most of the information needed can be obtained through direct contract with the appropriate source. The entrepreneur may need information on the following:

- **Location**:- The Company’s location and its accessibility to customers, suppliers, and distributors need to be determined.
- **Manufacturing**:- Operations basic machine and assembly operation need to be identified, as well as whether any of these operations would be subcontracted and by whom.
- **Raw materials**:- The raw materials needed and supplier’s names, addresses, and costs should be determined.
- **Equipment:-** The equipment needed should, be listed and whether it will be purchased or leased.
- **Labor skills**:- Each unique skill needed, the number of personnel in each skill, pay rate, and an assessment of where and how these skills will be obtained should be determined.
- **Space**:- The total amount of space needed should be determined, including whether the space will be owned or leased.
- **Overhead:-** Each item needed to support manufacturing, such as tools, supplies, utilities, salaries, and so on, should be determined.

Most of the above information as analysed should be incorporated directly into the business plan. Each item may require some research but each is necessary to those who will assess the business plan and considers funding the proposal.

Self Assessment Exercise 2:

What are the areas of need for generating information on operations?

3.4 Financial Information Needs

Before preparing the business plan, the entrepreneur must have a complete evaluation of the profitability of the venture. The assessment will primarily tell potential investors if the business will be profitable, how much money will be needed to launch the business and meet short –term financial needs, and how this money will be obtained; for example, stock and debt.

There are traditionally three areas of financial information that will be needed to ascertain the feasibility of the new venture:

- expected sales and expense figures for at least the first three years;
- cash flow figures for the first three years; and
- current balance sheet figures and pro forma balance sheets for the first three years.

Determination of the expected sales and expense figures for each of the first twelve months and each subsequent year is based on the marker information discusses earlier. Each expense item should be identified and give on a monthly basis for the year. Estimates of cash flow consider the ability of the new venture to meet expenses at designated times of the year. The cash flow forecast should identify the beginning cash, expected account receivable and other receipts, and all disbursements on monthly basis for the entire year.

Current balance sheet figures provide the financial conditions of the business at any particular time. They identify the assets of the business, the liabilities (what is owed), and the investment made by the owner or other partners.

Self Assessment Exercise 3:

What are the areas of need for generating information towards ensuring profitability of a new venture?

4.0 CONCLUSION

Generating data for a feasibility study, as you have understood from discussion above, is not just enough unless and until such pieces of information are generated for specific areas which are very relevant for the study. In assessing the viability of a new business venture some forms of information are necessary, and these relate to market information, operations information, and financial information among others.

The discussion above has been used to portray the areas of need for generating information for feasibility study generally, the specific areas of needs for marketing, operations, finance and other sundry information to be generated towards ensuring profitable business.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to feasibility study

Information Need for Feasibility Studies
Market Information

Operations Information Needs

Financial Information Needs

In the next study unit, we shall discuss the issue of business description.

6.0 TUTOR MARKED ASSIGNMENT

Mention and discuss the reasons for generating relevant information for specific aspects of feasibility study.

Solution to Self Assessment Exercises

SAE 1. The areas of need for generating information for feasibility study are as follows:

i. Prospects of the business

ii. Possible barriers to success

iii. Goals and objectives of the venture

iv. Framework for business/operation plan

v. Marketing plan

vi. Financial plan

vii. Management of the venture

viii. Business strategies

ix. Control and minimization of costs

x. Effective implementation of plans.

SAE 2. The areas of need for generating information on operations are as follows:

- Location:- The Company's location and its accessibility to customers, suppliers, and distributors need to be determined.
- Manufacturing:- Operations basic machine and assembly operation need to be identified, as well as whether any of these operations would be subcontracted and by whom.
- Raw materials:- The raw materials needed and supplier's names, addresses, and costs should be determined.
- Equipment:- The equipment needed should, be listed and whether it will be purchased or leased.
- Labor skills:- Each unique skill needed, the number of personnel in each skill, pay rate, and an assessment of where and how these skills will be obtained should be determined.
- Space:- The total amount of space needed should be determined, including whether the space will be owned or leased.
- Overhead:- Each item needed to support manufacturing, such as tools, supplies, utilities, salaries, and so on, should be determined.

SAE 3. The areas of need for generating information towards ensuring profitability of a new venture area as follows:

i. Expected sales and expense figures for five years;

ii. Cash flow figures for five years;

iii. Pro forma balance sheets for five years.

iv. Expected sales and expense figures for each of the first twelve months

v. Expected sales and expense figures for five years

7.0 REFERENCES/ FURTHER READINGS

Ezeanyagu J.E., (1995), Project Packaging for Business Funding – Methods and Case Studies, Enugu: Precision Printers and Publishers.

Hisrich, R. D. and Peters, M. P. (1998), Entrepreneurship, 4th Ed., Boston: Irwin McGraw-Hill, A Division of The McGraw-Hall Companies.

Imaga, E.U.L. (2003), Groundwork of Project Management and Feasibility Studies, Owerri: Ibeson Press.

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UNIT 3: BUSINESS DESCRIPTION

CONTENT

1.0 INTRODUCTION

In establishing and operating a business involves preparing a basic document that is meant to lay the profile of your business and the modus operandi of its operations. The business description portrays all the elements of the entire venture. Hence the document is prepared to dovetail the operational modalities from its location, management to operations generally. Therefore, in this study unit we shall discuss the intricacies involved in preparing the business description as an integral part of the business plan.

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Explain the business description.
- Describe a business venture.
- Identify and explain essential considerations in preparing business description.
- Write a business description.

- Outline the major components of a business description.

3.0 MAIN CONTENT

3.1 MEANING OF A BUSINESS DESCRIPTION

The business description is an integral part of the business plan. The business description is a written document prepared by the entrepreneur that describes all the relevant external and internal elements involved in starting and operating a new business venture.

You will recall from the introductory aspect this discussion that the business description is normally employed to put in a proper perspective the profile of a business venture and the modus operandi of its operations. Furthermore, it is also posited that the business description portrays all the elements of the entire venture. Hence the document incorporates the operational modalities of the business from its location, management to operations generally.

The business description can be prepared by the entrepreneur. Nevertheless, as a technical document, the entrepreneur may consult with lawyer, accountants, marketing consultants, and engineers who are versed in legal, financial and technical analyses of a business in its preparation.

Self Assessment Exercise 1:

Explain in simple terms the meaning of business description.

3.2 DESCRIPTION OF THE VENTURE

The description of the venture should be comprehensible so as to portray the size and scope of the business, elements of the products or services, the location and size of the business, the personnel and office equipment that will be needed, and the background of the entrepreneur.

In describing the venture some fundamental issues are to be taken into consideration. Such issues are related to the areas which are marshaled out in form of questions.

The business description will be narrated in an appropriate manner when the entrepreneur attempts to provide answers to the following questions:

1. What are the product(s) and/or service(s) of the business?
2. What are the peculiar features of the product(s) and/or service(s)?
3. What about patent, copyright, or trademark status?
4. Where will the business be located?
5. Is your building new or old and in need of renovations?

6. If there is need for renovation, what are cost implications?
7. Is the building leased or owned?
8. What are the terms of the lease?
9. Why is this building and location right for your business?
10. What are cadres and skills of personnel needed to operate the business?
11. What office equipment will be needed for the business?
12. Will equipment be purchased or leased?
13. What is the entrepreneur's business background?
14. What management experience does the entrepreneur have?
15. What are the personal data (education, age, special abilities and interests) of the entrepreneur?

The foregoing questions are by no means exhaustive but they only serve as guide to the description of a venture.

3.3 ESSENTIAL CONSIDERATIONS IN PREPARING BUSINESS DESCRIPTION

The essential areas of a business description are as follows:

1. The Industry

This is the overview of the industry in which the business will operate, industry trends, industry turnover and likely market share of the business in the industry.

2. The Market

This is the target market of the business, geographical location, and demography of the target market, their needs and plan to meet them.

3. Competition

This involves the number of competitors, their competitive advantages and the venture's strategies in meeting such challenges.

4. Marketing Strategies

This refers to venture's sales strategies, pricing policies, promotion strategies, and peculiar advantages of the venture's products/services.

5. **Management Plan**

This is a comprehensive plan on management resources of the venture; management team, external resources or outsourced personnel, emoluments and welfare packages for motivation.

6. **Operating Plan**

This describes the physical location of the business, strength of employees needed for the venture, facilities and equipment, inventory requirements and suppliers, production method, and manufacturing process.

The essential considerations as stated above are very much related to those to be considered in preparing the business plan. This is simply because, as you will recall, the business description is an integral part of the business plan.

Self Assessment Exercise 2:

What are the essential considerations in preparing the business description?

3.4 PREPARING THE BUSINESS DESCRIPTION

It is necessary that when describing the business, you emphasize the details of the critical areas such as follows:

1. **Form of Business**
You have to sate form of the venture such as proprietorship, partnership, or company.

2. **Business type**
You have to state whether it is merchandizing (involving buying and selling), manufacturing (setting factory to produce the products) or service-oriented involving setting up office premises to render the intended services.

3. **Location of the Business**
The location of the business refers to the precise address that can be used to access the business by prospective financiers and customers.

4. **Product or Service of the business**
Specify the nature of the product or service intended to provide by the business to the prospective customers.

5. Nature of Ownership

You have to state the ownership status whether it is wholly owned by you, a franchise, takeover of an existing business or a new one entirely.

6. Sales and Revenue Projections:

You have to state a summary of the expected sales volume or magnitude of turnover, the revenue and cost implications, and the probable returns or profit margins over some period of time.

7. Hours of Business

You have to state the hours and days of operations of the business

8. Management

You have to state the staff strength you are going to operate the business with, their qualifications, experience, special knowledge they are bring into the business.

Self Assessment Exercise 3:

What are the critical areas necessary for preparing business description?

3.5 OUTLINE OF A BUSINESS DESCRIPTION

The outline of a business description incorporates relevant sections of the description which are used to detail out the vital information on the new venture the entrepreneur intends to operate.

1) The Business

i. Name and address of business

ii. Name(s) and address(es) of principal promoters

iii. Nature of business

2) Location

i. Address of operational base

ii. The site or geographical area

iii. The space earmarked for use

iv. Nature of building for use

3) The Industry

i. Trends in the industry

ii. Profile of the competitors

iii. Market segmentation of the industry

iv. Future outlook of the Industry

4) Product/Service

i. Nature of the product or service

ii. Special features of the product

iii. Special benefits to the users/consumers

iv. Nature of externalities of the product

5) Operation/Office Equipment

i. Type/number of equipment for the business

ii. Type/number of machines for the business

iii. Fixtures/fittings for the business

6) Personnel

i. Number of full- and part- term staff required

ii. Number of personnel for the business

iii. Calibre of staff for the business

iv. Remuneration for the staff

v. Number of superior staff

7) Production

(if it is a manufacturing firm)

i. Type of production

ii. Manufacturing process

iii. Physical plant

iv. Machinery and equipment

v. Name(s) of suppliers of raw materials

8) Marketing Plan

i. Pricing

ii. Distribution

iii. Promotion

iv. Demand Forecast

v. Special offers

9) Management

i. Background of the entrepreneur(s)

ii. The management team

iii. Background on Management team

iv. Responsibilities of members of management team

v. Board of Advisors & responsibilities

10) Sales and Revenue

i. Volume Sales/turnover

ii. Revenue generation

iii. Preliminary expenses

iv. Initial cost of operation

v. Profits/returns

The outlines of a business description are by no means exhaustive. Hence such outlines are meant to serve as guise as to what is expected in a business description.

4.0 CONCLUSION

The business description as a basic document is very essential in establishing and operating a business. The document is meant to incorporate the profile of your business and modality for operating the business. The business description is normally prepared to portray all the elements of the entire venture, which takes into consideration some critical areas of operation. Therefore, the document should be prepared as to complement the business plan.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to business description.

- Meaning of a Business Description
- Description of the Venture

- Essential Considerations in Preparing Business Description
- Preparing the Business Description
- Outline of a Business Description

In the next study unit, we shall discuss the issue of location or siting of business.

6.0 TUTOR MARKED ASSIGNMENT

What are the outlines of a business description?

Solution to Self Assessment Exercises:

SAE 1. The business description is a written document prepared by the entrepreneur that describes all the relevant external and internal elements involved in starting and operating a new business venture.

SAE 2. The essential considerations in preparing the business description are as follows.

i. The Industry

This is the overview of the industry in which the business will operate, industry trends, industry turnover and likely market share of the business in the industry.

ii. The Market

This is the target market of the business, geographical location, and demography of the target market, their needs and plan to meet them.

iii. Competition

This involves the number of competitors, their competitive advantages and the venture's strategies in meeting such challenges.

iv. Marketing Strategies

This refers to venture's sales strategies, pricing policies, promotion strategies, and peculiar advantages of the venture's products/services.

v. Management Plan

This is a comprehensive plan on management resources of the venture;

management team, external resources or outsourced personnel, emoluments and welfare packages for motivation.

vi. Operating Plan

This describes the physical location of the business, strength of employees needed for the venture, facilities and equipment, inventory requirements and suppliers, production method, and manufacturing process. The essential considerations as stated above are very much related to those to be considered in preparing the business plan. This is simply because, as you will recall, the business description is an integral part of the business plan.

SAE 3. The critical areas for preparing a business description are as follows:

i. Form of Business

You have to sate form of the venture such as proprietorship, partnership, or company.

ii. Business type

You have to state whether it is merchandizing (involving buying and selling), manufacturing (setting factory to produce the products) or service-oriented involving setting up office premises to render the intended services.

iii. Location of the Business

The location of the business refers to the precise address that can be used to access the business by prospective financiers and customers.

iv. Product or Service of the business

Specify the nature of the product or service intended to provide by the business to the prospective customers.

v. Nature of Ownership

You have to state the ownership status whether it is wholly owned by you, a franchise, takeover of an existing business or a new one entirely.

vi. Sales and Revenue Projections:

You have to state a summary of the expected sales volume or magnitude of turnover, the revenue and cost implications, and the probable returns or profit margins over some period of time.

vii. Hours of Business

You have to state the hours and days of operations of the business

viii. Management

You have to state the staff strength you are going to operate the business with, their qualifications, experience, special knowledge they are bring into the business.

7.0 REFERENCES/ FURTHER READINGS

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UNIT 4: LOCATION OR SITING OF BUSINESS

CONTENT

1.0 INTRODUCTION

It is important for entrepreneurs to locate their businesses well so that they are able to thrive in an increasingly competitive market. This is in view of the fact the location of your business can determine its success or failure. Therefore, the choice of location in business operation is very strategic in establishing and running an enviable and profitable venture. Hence the discussion in this study unit revolves around the location of business.

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Explain the essence of location in business.
- Mention and explain the considerations in location of business.
- Discuss determination of optimum location in business operation.

3.0 MAIN CONTENT

3.1 LOCATION OF A BUSINESS

The location of any business may be considered strategic in its operations as well as its success, particularly if the business is service oriented. Nevertheless, location is also strategic to decision in establishing a manufacturing venture due to some obvious reasons.

In consequence, the emphasis on location in the business plan is a function of the nature and type of business to be established and operated by an entrepreneur. In assessing the building (e.g., for service venture) or space (e.g., for manufacturing venture), that the business will occupy, the entrepreneur may have to evaluate factors such as parking space, access from road networks to facility, access to customers, suppliers, distributors, and delivery vehicles.

There are other considerations in the choice of building and or site which include the presence of allied businesses, availability of utilities, proximity to large concentration of population, easy of identification by prospective customers, and availability of public convenience, among others.

In the case of building the entrepreneur ay make do with available structure especially if the available building belongs to the entrepreneur. Hence the issue of strategic consideration since the use of personal property may relief the entrepreneur some financial burden in terms of cost of leasing another building for his or her business operations.

In terms of government regulations or zoning laws governing the location of particular business, legal experts can be consulted in order not to run afoul of the law. Management experts can also be consulted for help in terms of an appropriate place of choice for locating a particular business operation. The city or town (enlarged) local map may help provide idea on choice of location to the perspective entrepreneur with respective to roads, highways, access, and other vital information.

Self Assessment Exercise 1:

What are the considerations for assessing building or site for business venture?

3.2 CONSIDERATIONS IN LOCATION OF BUSINESS

There are vital factors to consider in the choice of location of a business. Such factors are as highlighted and discussed below.

1. Facilities

These are some of the operational amenities required by the business. Some geographical areas have appropriate amenities for effective operations of peculiar enterprises and therefore should be considered. Such facilities in relation to operational location include banking facilities, water supply, internet centres, good road network, security and telecommunication network.

2. Land

This refers to the nature of land in relation to the soil structure that will withstand the type of machines and equipment that will be installed and utilized for the business.

Availability of large tracts of flat land for industries especially large-scale heavy industries or industries that use conveyor belts in their production process. The cost of the land is an important consideration in industrial location. Thus most industries are located far away from city centres where the prices are lower.

3. Energy and Water Supplies

A business establishment needs some utilities such as electricity and water supplies so as to facilitate its operations. All businesses cannot be operated successfully without power supply. The absence of power supply particularly has ruined the fortune of many businesses to the extent that some have been crippled in the course of operations.

Industries that require large supplies of water or power need to be near rivers or energy sources as the energy resource is either too bulky and costly to transport or immovable, like hydro-electric power. Technological advances in power generation and the transport of energy has caused a decline in proximity to energy sources.

4. Nature of business

The nature and type of your business is the most important determinant of where a business should be located. Businesses that are service oriented should be located in strategic areas of the towns and cities in order to attract customers. However, in the case of manufacturing organizations it may be necessary to locate in strategic areas but at the outskirts or areas designated for such purpose.

5. Funds

The availability of funds for purchasing land and machinery, installing facilities and employment of labour influences the location of industries. The amount of money you can afford to obtain premises must of course come into play. Most first time entrepreneurs will be renting due to budget constraints. Always try and secure premises that provide the best value for your money considering the nature of business.

6. Space required

Certain types of business require very large amounts of space. For example, car dealerships and car rentals require large space to park their vehicles. This may mean looking for an out of town cheap location.

7. Special facilities needed

Certain types of businesses require special facilities to carry out their business effectively. For example IT companies have some very special mechanical, electrical, plumbing, and fire suppression requirements. Server rooms and computer areas need dedicated cooling units. These must be taken into consideration before settling on a business location.

8. Raw Materials

Resource-based industries like dairy industry or iron and steel industry are located near to raw material sources because the raw materials are bulky or perishable, making it difficult and costly to transport over a long distance. Weight-losing industries use bulky raw materials to produce a compact finished product and tend to locate near the source of raw materials.

9. Labour

An available pool of labour is essential to support the industrial production process. The cost, quality and availability of labour is different in different locations: high technology industries or research and development companies are located in areas where the workforce is highly-educated or skilled and labour-intensive industries are located in regions where there are vast numbers of unskilled and low-cost labour.

10. Market

Markets must be present in order to support industrial production. Weight-gaining industries use compact raw materials to produce a bulky finished product and tend to locate near the major market. Industries that supply perishables are market-oriented to save transport costs.

11. Transport

Accessible areas with efficient transport networks draw more industries as quick transportation can take place and transport costs can be lowered.

12. Scale of Operation

Large scale production of goods enables the industrialist to enjoy economies of scale as fixed production costs are lowered. Industries can also reap benefits of economies of scale by location close to firms engaged in similar industries through the sharing of facilities, knowledge, expertise and manpower resources. This is known as agglomeration economies. Industries are located near to related industries to enjoy the benefits of industrial linkages.

13. Government

The presence of a supportive and stable government encourages industrial development - offers a safe and secure investment climate, gives financial incentives and subsidies and provides basic infrastructure and sanitary amenities.

Self Assessment Exercise 2:

Mention and explain the vital factors to consider in location of business venture.

3.3 DETERMINATION OF OPTIMUM LOCATION

The location issue of the business also comes to play in technical analysis. Technical feasibility depends largely on location, because substantial differences do exist in the availability, accessibility, quality and cost of various factor inputs at different locations. The selection of the best location must be guided by the objectives of the entity for which the analysis is being undertaken, that is, a guarantee of maximum return rate from operations of the firm or the highest economic and social profitability from the rational point of view.

Location study, according to Hoover (1963), consists of analyzing locational forces which include:

- the sum of the total transportation costs of the inputs (raw materials) required by the project and the physical distribution costs of the output produced by the project, which must be minimum,
- the availability and relative costs of resource inputs which must yield minimum production or processing costs, and
- favourable environment with regard to the availability of land and buildings, taxes and regulations, general living conditions, climate, administrative facilities, centralization or decentralization policies of the government, environmental impact policies such as elimination of effluent, and offensive odours, waste disposal and so on.

The best location is that in which the resultant of these forces produces the maximum profit or minimum cost. These forces are now discussed in turns.

3.3.1 Influence of Transportation Cost on choice of Location

An analysis of the transportation costs of the requisite raw materials to the project's site, that is, the procurement costs), and those of the resulting output to the market (that is, the distribution costs), usually referred to as transfer costs point to three possible locations:

i. near the source of raw materials,
ii. near the market, and

iii. at an intermediate point

The best location is that which gives the lowest total transport costs, that is, the sum of both procurement and distribution costs.

i) Factors Influencing location Near Source of Raw Material:

Projects are located near the source of raw material if:

- They have the characteristics of considerable weight loss at the production stage, for example, the initial processing crude material such as crushing of sugar cane or smelting of ores and so on.
- They involve large requirements of fuel. Such projects usually involve a high proportion of weigh loss since the weight of the fuel used does not enter into that of the final product. Most of the industries using large amounts of fuel are those engaged in early stages of processing; for example metallurgy, manufacturing of cement, glass, calcium carbide and synthetic nitrates and so on.
- The relative weights of materials and finished products are the same, but the procurement cost per kilogram, for example, ginning and baling of cotton, food-preserving industries, and so on.

Self Assessment Exercise 3:

Outline and explain some factors which influence location of a project near source of raw materials.

ii) Factors Influencing Location near the Market:

Projects are located near the market if:

- They are characterized by the considerable weight gain at the production stage. The production process of such projects involves the incorporation of large quantities of "ubiquitous" material like water. Such material is found virtually everywhere and does not involve any transfer cost, but adds to the weight of the final product; for example, soft drinks, beer and ice-blocks.
- The production process are in the intermediate and last stages of production and are therefore more perishable, more valuable and involve more distribution cost per kilogram. Therefore, they are located closed to the final consumers.

iii) Factors Influencing location at an Intermediate Point

Transportation costs may also influence the location of a project at a point between the source of raw materials and the market. This phenomenon usually occurs where two modes of transportation meet; for example, the railway and the water route between the source of raw material and the market.

It is best to locate at the intermediate point if:

(i) both the raw material and the finished product are cheap and bulky;
(ii) the transportation costs of raw material and finished product are the same; and
(iii) expenses of trans-ship is great. Trans-shipment cost may involve among other things the provision of warehouses and strong security outfit.

4.0 CONCLUSION

Business operations require strategic location in order to ensure its success. Location is very strategic to decision in establishing either service oriented or manufacturing venture due to some obvious reasons such as defined patronage, reasonable share of market, survival, and profitability, among others. In essence, the stress on location in the business plan is a function of the nature and type of business among other factors to be considered for the selection of an appropriate location for a venture.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to location of business.

- Location of a Business
- Considerations in Location of Business
- Determination of Optimum Location

In the next study unit, we shall discuss the issue of management and production.

6.0 TUTOR MARKED ASSIGNMENT

Mention and explain the vital factors to consider in location of business venture.

Solution to Self Assessment Exercises:

SAE 1. The considerations for assessing building or site for business venture are as follows:

- Parking space
- Access from road networks to facility
- Access to customers
- Access to suppliers

- Access to distributors
- Access to delivery vehicles
- Government regulations
- Zoning laws governing the location of particular business
- Presence of allied businesses
- Availability of utilities
- Proximity to large concentration of population
- Easy of identification by prospective customers, and
- Availability of public convenience, among others.

SAE 2. The vital factors to consider in location of business venture are as follows.

i. Facilities

These are some of the operational amenities required by the business. Some geographical areas have appropriate amenities for effective operations of peculiar enterprises and therefore should be considered.

ii. Land

Availability of large tracts of flat land for industries especially large-scale heavy industries or industries that use conveyor belts in their production process. The cost of the land is an important consideration in industrial location. Thus most industries are located far away from city centres where the prices are lower.

iii. Energy and Water Supplies

A business establishment needs some utilities such as electricity and water supplies so as to facilitate its operations. All businesses cannot be operated successfully without power supply. The absence of power supply particularly has ruined the fortune of many businesses to the extent that some have been crippled in the course of operations.

iv. Nature of business

The nature and type of your business is the most important determinant of where a business should be located. Businesses that are service oriented should be located in strategic areas of the towns and cities in order to attract customers. However, in the case of manufacturing organizations it may be necessary to locate in strategic areas but at the outskirts or areas designated for such purpose.

v. Funds

The availability of funds for purchasing land and machinery, installing facilities and employment of labour influences the location of industries. The amount of money you can afford to obtain premises must of course come into play. Most first time entrepreneurs will be renting due to budget constraints. Always try and secure premises that provide the best value for your money considering the nature of business.

vi. Space required

Certain types of business require very large amounts of space. For example, car dealerships and car rentals require large space to park their vehicles. This may mean looking for an out of town cheap location.

vii. Special facilities needed

Certain types of businesses require special facilities to carry out their business effectively. For example telecommunication companies have some very special mechanical, electrical, plumbing, and fire suppression requirements. Server rooms and computer areas need dedicated cooling units. These must be taken into consideration before settling on a business location.

viii. Raw Materials

Resource-based industries like dairy industry or iron and steel industry are located near to raw material sources because the raw materials are bulky or perishable, making it difficult and costly to transport over a long distance.

Weight-losing industries use bulky raw materials to produce a compact finished product and tend to locate near the source of raw materials.

ix. Labour

An available pool of labour is essential to support the industrial production process. The cost, quality and availability of labour is different in different locations: high technology industries or research and development companies are located in areas where the workforce is highly-educated or skilled and labour-intensive industries are located in regions where there are vast numbers of unskilled and low-cost labour.

x. Market

Markets must be present in order to support industrial production. Weight-gaining industries use compact raw materials to produce a bulky finished product and tend to locate near the major market. Industries that supply perishables are market-oriented to save transport costs.

xi. Transport

Accessible areas with efficient transport networks draw more industries as quick transportation can take place and transport costs can be lowered.

xii. Economies of Scale

Large scale production of goods enables the industrialist to enjoy economies of scale as fixed production costs are lowered. Industries can also reap benefits of economies of scale by location close to firms engaged in similar industries through the sharing of facilities, knowledge, expertise and manpower resources. This is known as agglomeration economies. Industries are located near to related industries to enjoy the benefits of industrial linkages.

xiii. Government

The presence of a supportive and stable government encourages industrial development - offers a safe and secure investment climate, gives financial incentives and subsidies and provides basic infrastructure and sanitary amenities.

SAE 3. Some factors which influence location of a project near source of raw materials are as follows:

- Characteristics in relation to weight loss at the production stage, for example, the initial processing crude material such as crushing of sugar cane or smelting of ores and so on.
- Requirements of fuel. Such projects usually involve a high proportion of weigh loss since the weight of the fuel used does not enter into that of the final product. Most of the industries using large amounts of fuel are those engaged in early stages of processing; for example metallurgy, manufacturing of cement, glass, calcium carbide and synthetic nitrates and so on.
- Relative weights of materials and finished products are the same, but the procurement cost per kilogram, for example, ginning and baling of cotton, food-preserving industries, and so on.

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MODULE 2

UNIT 5: MANAGEMENT AND PRODUCTION

CONTENT

1.0 INTRDUCTION

Some business ventures are specifically established for the purpose of manufacturing products. Therefore, for such an establishment it becomes very imperative for the entrepreneur to draw up a production management plan. The rationale for such a plan is for the entrepreneur to the fore the manufacturing process, method of production, location and pecuniary implications of the plan. The discussion in this study unit is centered on production ant strategies for mitigating possible risks inherent in the operations.

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Discuss the production plan
- Explain the marketing plan
- Discuss the venture plan
- Identify and explain strategies for mitigating risk
- Discuss the financial plan

3.0 MAIN CONTENT

3.1 PRODUCTION PLAN

A production plan is necessary in the event that the new venture is a manufacturing operation. This plan should describe the complete manufacturing process. If some or all of the manufacturing process is to be subcontracted, the plan should describe the location, reasons for selection, costs, subcontractor(s), and any contracts that have been completed.

If the manufacturing is to be carried out in whole or in part by the entrepreneur, he or she will need to describe:

- the physical plant layout;
- the machinery and equipment needed to perform the manufacturing operations;
- raw materials and suppliers' names, addresses, and terms;
- costs of manufacturing; and
- any future capital equipment needs.

In a manufacturing operation, the discussion of these items will be important to any potential investor in assessing financial needs.

In the event that the venture is not a manufacturing operation but a retail store, this section would be used to describe the merchandizing plan, the purchasing of merchandize, and inventory control system, as well as the storage needs.

The preparation of the production plan involves providing answers for the following questions:

1. Will you be responsible for all or part of the manufacturing operation?
2. If some manufacturing is subcontracted, who will be the subcontractor(s)?
3. Why were these subcontractors selected?
4. What are the costs of the subcontracted manufacturing?

5. What will be layout of the production process?
6. What equipment will be needed immediately for manufacturing?
7. What raw materials will be needed for manufacturing?
8. Who are the suppliers of new materials and appropriate costs?
9. What are the costs of manufacturing the product?
10. What are the future capital equipment needs of the ventures?

If the venture is a retail operation in service delivery, the following questions are very relevant:

1. From whom will merchandize be purchased?
2. How will the inventory control system operate?
3. What are storage needs of the venture and how will they be promoted?

Self Assessment Exercise 1:

What are the relevant areas of manufacturing that are to be included in the production plan?

3.2 MARKETING PLAN

The marketing plan is an important part of the business plan since it describes how the product or service will be distributed, priced, and promoted. Specific forecasts for product or service are included in order to project profitability of the venture.

Potential investors regard the marketing plan as critical to the success of the new venture. Thus, the entrepreneur should make every effort to prepare as comprehensive and detailed a plan as possible so that investors can be clear as to what the goals of the venture are and what strategies are to be implemented to effectively achieve these goals.

Marketing planning will be an annual requirement but subject to careful monitoring and changes made on a weekly or monthly basis for the entrepreneur. The plan should be regarded as the thoroughfare chart for short-term decision making.

3.3 VENTURE PLAN

The venture plan is the part of the business plan that describes the venture’s form of ownership – that is, proprietorship, partnership, or a corporation. If the venture is a partnership, the terms of the partnership should be included.

If the venture is a corporation, it is important to detail the shares of stock authorized, share options, names, and addresses and resumes of the directors and officers of the corporation.

It is also helpful to provide an organization chart indicating the line of authority and the responsibilities of the members of the organization.

The description of the venture plan involves providing answers to the following pertinent questions:

1. What is the form of ownership of the organization?
2. If a partnership, who are the partners and what are the terms of agreement?
3. If incorporated, who are the principal shareholders and how much stock do they own?
4. What type and how many shares of voting or nonvoting stock have been issued?
5. Who are members of the board of directors? (Given names, addresses, and resumes)
6. Who is each member of the management team and what is her or his background?
7. What are the roles and responsibilities of each member of the management team?
8. What are the salaries, bonuses or other forms of payment for each member of the management team?

Self Assessment Exercise 2:

What are the relevant considerations in description of the venture plan?

3.4 RISK MITIGATING PLAN

It is necessary for the various types of risk that can plague the business need to be analyzed and the plans for mitigating them clearly spelt out in the business plan. The assessment of potential risks inherent in the venture involves identifying the potential hazards and by implication, the entrepreneur should identify the alternative strategies for dealing with such risks.

In essence, an assessment of risk prepares the entrepreneur for mapping out effective strategies to deal with them. Major risks for a new venture could result from a competitor's reaction; weaknesses in the marketing, product, or management team; and new advances in technology that might render the new product obsolete. Even if these factors present no risks to the new venture, the business plan should discuss why that is the case.

Furthermore, it is also useful for the entrepreneur to provide alternative strategies should any of the above risk factors occur. These contingency plans and strategies illustrate to the potential investor that the entrepreneur is sensitive to important risks and is prepared should any occur.

3.5 FINANCIAL PLAN

The financial plan like the marketing, production, and organization plans is an important part of the business plan. Financial plan in terms of financial projections of key financial data helps determine economic feasibility and necessary financial investment commitment in the business venture.

It is also to determine the potential investment commitment needed for the new venture and indicates whether the business plan is economically feasible. Generally, three financial areas are discussed in this section of the business plan.

The first area is for the entrepreneur to summarize the forecasted sales and the appropriate expenses for at least the first three years, with the first year's projections provided monthly. It includes the forecasted sales, cost of goods sold, and the general and administrative expenses. Net profit after taxes can then be projected by estimating incomes taxes.

The second major area of financial information needed is cash flow figures for three years, with the first year's projections provided monthly. Since bills have to be paid at different times of the year, it is important to determine the demands on cash on a monthly basis, especially in the first year. Remember that sales may be irregular, and receipts from customers may also be spread out, thus necessitating the borrowing of short-term capital to meet fixed expenses such as salaries and utilities.

The last financial item needed in this section of the business plan is the projected balance sheet. This shows the financial condition of the business at a specific time.

It summarizes the assets of a business, its liabilities (what is owed), the investment of the entrepreneur and any partners, and retained earnings (or cumulative losses). Any assumptions considered for the balance sheet or any other item in the financial plan should be listed for the benefit of the potential investor.

Self Assessment Exercise 3:

What are the major financial areas to be considered in financial plan?

4.0 CONCLUSION

A new business venture can be specifically established for manufacturing of products. As you have understood in the foregoing analysis, for such an establishment it becomes very imperative for the entrepreneur to draw up a production management plan besides the plans for marketing, finance, risk management, and the description of the venture itself.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to management and production plan of a new venture.

- Production Plan
- Marketing Plan
- Venture Plan
- Risk Mitigating Plan
- Financial Plan

In the next study unit, we shall discuss the technical analysis of a new business.

6.0 TUTOR MARKED ASSIGNMENT

What are the relevant considerations in description of the venture plan?

Solution to Self Assessment Exercises:

SAE 1. The relevant areas of manufacturing that are to be included in the production plan are as follows:

i. The physical plant layout

ii. The machinery and equipment needed to perform the manufacturing operations

iii. Raw materials and suppliers' names, addresses, and terms of supplies

iv. Costs of manufacturing

v. Any future capital equipment needs

vi. Responsibility for manufacturing operations

vii. Layout of the production process

viii. Suppliers of new materials and appropriate costs

SAE 2. The relevant considerations in description of the venture plan are as follows:

i. Form of ownership of the business.

ii. The partners and the terms of agreement if a partnership.

iii. The principal shareholders and stock do they own if incorporated.

iv. Type and how many shares of voting or nonvoting stock issued.

v. Members of the board of directors with their names, addresses, and resumes.

vi. Members of the management team and their background.

vii. Roles and responsibilities of each member of management team.

viii. Emolument for each member of the management team.

SAE 3. The major financial areas to be considered in financial plan are as follows.

i) Forecasted sales and the appropriate expenses for the five years, with the first year's projections provided monthly.

ii) Cash flow figures for five years, with the first year's projections provided monthly

iii) Loan repayment and interest payment schedule

iv) Projected income statement showing profit or loss

v) Projected balance sheet showing the financial condition of the business, assets of a business, its liabilities, the investment of the entrepreneur and any partners, and retained earnings.

7.0 REFERENCES/ FURTHER READING

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UNIT 6: TECHNICAL ANALYSIS

CONTENT

1.0 INTRDUCTION

The technical analysis is usually carried out with the intent of obtaining exhaustive and authoritative information on all the various factor inputs required for a business. Essentially the technical analysis aims at determining the technical requirements of the business, location that would be most advantageous, and size of business that would be optimum. Therefore, the analysis requires the study of the availability, quality, accessibility and price of all the requirements for the business. All this constitutes subject of discussion in this study unit

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Mention and discuss determinants of Optimum Location
- Explain the Determination of Optimum Size
- Discuss the Size of Business and the Market

- Identify and explain Business Size and Administrative Capacity
- Discuss the Business Size and Technique of Production
- Explain Business Size and Location

3.0 MAIN CONTENT

3.1 DETERMINATION OF OPTIMUM LOCATION

The location issue of the business also comes to play in technical analysis. Technical feasibility depends largely on location, because substantial differences do exist in the availability, accessibility, quality and cost of various factor inputs at different locations. The selection of the best location must be guided by the objectives of the entity for which the analysis is being undertaken, that is, a guarantee of maximum return rate from operations of the firm or the highest economic and social profitability from the rational point of view.

Location study, according to Hoover (1963), consists of analyzing locational forces which include:

- the sum of the total transportation costs of the inputs (raw materials) required by the project and the physical distribution costs of the output produced by the project, which must be minimum,
- the availability and relative costs of resource inputs which must yield minimum production or processing costs, and
- favourable environment with regard to the availability of land and buildings, taxes and regulations, general living conditions, climate, administrative facilities, centralization or decentralization policies of the government, environmental impact policies such as elimination of effluent, and offensive odours, waste disposal and so on.

The best location is that in which the resultant of these forces produces the maximum profit or minimum cost. These forces are now discussed in turns.

3.1.1 Influence of Transportation Cost on choice of Location

An analysis of the transportation costs of the requisite raw materials to the project's site, that is, the procurement costs), and those of the resulting output to the market (that is, the distribution costs), usually referred to as transfer costs point to three possible locations:

i. near the source of raw materials,

ii. near the market, and

iii. at an intermediate point

The best location is that which gives the lowest total transport costs, that is, the sum of both procurement and distribution costs.

i) Factors Influencing location Near Source of Raw Material:

Projects are located near the source of raw material if:

- They have the characteristics of considerable weight loss at the production stage, for example, the initial processing crude material such as crushing of sugar cane or smelting of ores and so on.
- They involve large requirements of fuel. Such projects usually involve a high proportion of weigh loss since the weight of the fuel used does not enter into that of the final product. Most of the industries using large amounts of fuel are those engaged in early stages of processing; for example metallurgy, manufacturing of cement, glass, calcium carbide and synthetic nitrates and so on.
- The relative weights of materials and finished products are the same, but the procurement cost per kilogram, for example, ginning and baling of cotton, food-preserving industries, and so on.

Self Assessment Exercise 1:

Outline and explain some factors which influence location of a project near source of raw materials.

ii) Factors Influencing Location near the Market:

Projects are located near the market if:

- they are characterized by the considerable weight gain at the production stage. The production process of such projects involves the incorporation of large quantities of "ubiquitous" material like water. Such material is found virtually everywhere and does not involve any transfer cost, but adds to the weight of the final product; for example, soft drinks, beer and ice-blocks.
- The production process are in the intermediate and last stages of production and are therefore more perishable, more valuable and involve more distribution cost per kilogram. Therefore, they are located closed to the final consumers.

iii) Factors Influencing location at an Intermediate Point

Transportation costs may also influence the location of a project at a point between the source of raw materials and the market. This phenomenon usually occurs where two modes of transportation meet; for example, the railway and the water route between the source of raw material and the market.

It is best to locate at the intermediate point if:

i) both the raw material and the finished product are cheap and bulky;

ii) the transportation costs of raw material and finished product are the same; and

iii) expenses of trans-ship is great. Trans-shipment cost may involve among other things the provision of warehouses and strong security outfit.

3.1.2 Influence of Production or Processing Costs

In some line of business, transportation costs vary very little with location, that is, they are not important factors in location, when compared with production or processing costs, for example, in the manufacture of type-writers, alarm clocks and so on.

Processing cost include direct labour costs, raw materials, cost of administration, electric power, interest, rents, water, fuel, royalties and others. The cost may differ from location to location. The best location is where the combination of productive services necessary to make the product is available and can be obtained at minimum cost per unit of output.

3.1.3 Influence of Government Spatial Policy

Transportation and processing costs are the two most important factors in location, but other factors such as the decentralization policy of government, living conditions, administrative, housing and social infrastructural facilities, and others should not be ignored.

The government may adopt a deliberate policy to disperse industries to some depressed areas by providing generous direct incentives to enterprises wishing to comply. For example, credit facilities, fiscal incentives and infrastructural facilities that may reduce overhead and processing costs may be provided. These factors should be studied and reported in the determination of the best location.

Self Assessment Exercise 2:

Enumerate various factors that influence location of a business project.

3.2 DETERMINATION OF OPTIMUM SIZE

The determination of the optimum size of the plant is governed by technical-economic considerations. Conflicts often do arise between the size of the plant suitable for a mass market, and the size that would yield the competitive lowest unit production cost. The following illustrates cost-volume relationship in the company XYZ.

Figure 6.1: Cost Volume Relationship: Company XYZ

	A	**B**	**C**
Volume (Units)	100,000	200,000	400,000
Total Fixed Investment	100	140	240
Unit Cost (Index):			
Material	100	96	92
Labour	100	92	76
Fixed Overhead	100	70	60
Total Unit Cost	100	92	87
Unit factory cost (total cost less materials)	100	85	76

The figure above indicates the size C produces the lowest unit cost. Should the project therefore choose size C? The problem involved in the choice of the right size calls for exhaustive examination.

In economic theory, the optimum size depends on the objective function and the constraints. If in project analysis the objective is to maximize the discounted net benefits, then the problem may be expressed as follows:

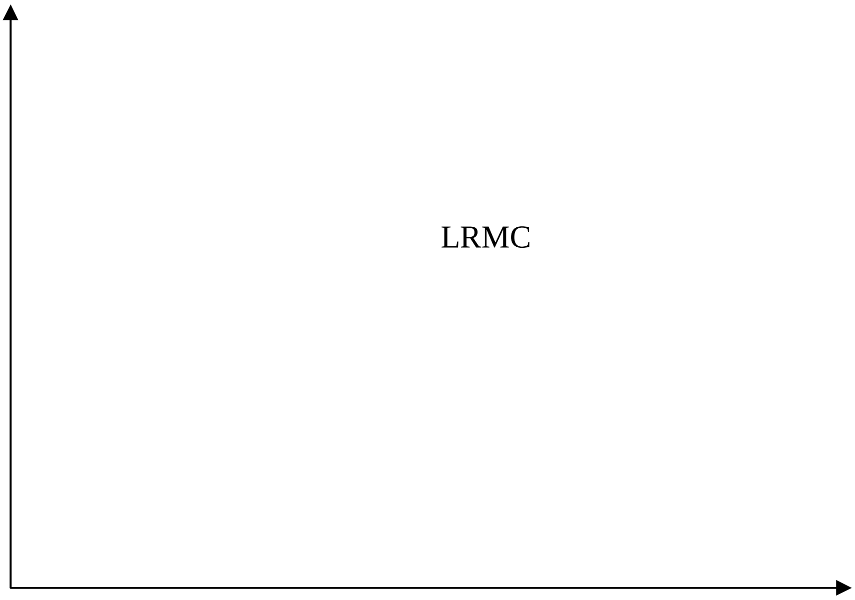
Max. N = B(k) – C(K), where N = discounted net benefit
B = discounted benefit as a function of size K C = discounted costs as a function of size K

dN/dK = dB/dK – dC/dK = 0 Therefore, dB/dK=dC/dK where
dB/dK and dC/dK are respectively long-run marginal benefit (LRMB) and long-run marginal cost (LRMC).

Thus, optimal scale is reached where LRMB equals LRMC, that is the unconstrained optimum size is reached where the marginal benefit cost ratio is equal to one. This is however the first order condition, for it is possible to have this condition satisfied and yet not to have the optimal scale as illustrated in figure 6.2

Figure 6.2: Determination of Optimum Scale

PV



The optimal condition is satisfied at A and B, but both of them cannot be optimal, for it still pays the project to increase scale and output beyond point A as additions to benefit are greater than additions to cost. Therefore, there is a second order condition which stated that:

$$dN^2/dK^2 = d^2B/dK^2 - d^2C/dK^2 < 0$$

Therefore, $d^2B/dK^2 < d^2C/dK^2$ or $d^2C/dK^2 = d^2B/dK^2$

Thus, the second order condition states that at the point where the long-run marginal benefit curve intersects the long-run marginal cost curve, the slope of the long-run marginal cost curve must be greater the slope of the long-run marginal benefit curve. Thus, OK_2 is the unconstrained optimum size.

Thus if the choice is concerned with unconstrained optimum size figure 6.2 indicates that the marginal benefit (ΔB) and the marginal cost (ΔC) of each size alternative should be calculated and plotted against plant size (or plant capacity), the point of the intersection of the ΔB and ΔC curves corresponding with the larger or largest plant size indicates the unconstrained optimum size. Alternatively, the $\Delta B/\Delta C$ ratio of each size alternative should be calculated, the larger or largest size that yields a ratio of one indicates the unconstrained optimum size.

The relevant considerations based on foregoing are:

(i) that the market (demand) is very large and it imposes no limitation on the quantity of the product that can be sold;

(ii) that distribution costs is zero;

(iii) that there is an efficient and adequate administrative capacity to operate the optimum plant size; and

(iv) that the facility produces only one type of product (that is, it is not a multi-product undertaking).

Self Assessment Exercise 3:

List and explain relevant considerations in optimum size of a project.

3.3 SIZE OF BUSINESS AND THE MARKET

The size of the Market gives the guide to the feasible range of alternatives of project size. There are four possible situations:

i. the volume of demand (D) is smaller than the minimum possible size (M) of the project; that is D<M;

ii. the volume of demand (D) is equal to the minimum possible size (M); that is D=M

iii. the volume of demand is (D) is larger the possible minimum size or any intermediate size, but less than the largest possible (L); that is M<D<L:

iv. the volume of demand is so large that it does not place any limitation on the scale of production, that is D>L

From above the analysis indicates that:

For (i), the project is premature and there is no justification for its execution. For (ii) there is only one size alternative, and that is the minimum size.

For (iii) and (iv), there are many alternatives and a project analyst is confronted with problem of choice.

When the market size presents many alternatives for the size of the project, some elimination can take place on the basis of:

(a) administrative capacity;

(b) techniques of production; and

(c) location (or distribution) cost.

3.4 BUSINESS SIZE AND ADMINISTRATIVE CAPACITY

Some large business may call for high levels of operation, which require both efficient and adequate administrative capacity. If this is lacking, it may be advisable to operate on a small scale at first, and then expand later as experience is gained. Thus, administrative capacity may constrain or limit the optimum size of a project.

3.5 BUSINESS SIZE AND TECHNIQUE OF PRODUCTION

Some production techniques: require a minimum scale of operation below which costs would be so high that it would be unreasonable to operate at low capacity; size alternatives that would necessitate operation at low capacity; and size alternatives that would necessitate operation at low capacity would thus be eliminated.

3.6 BUSINESS SIZE AND LOCATION

The size of a project and location are related from two angles:

(i) from the geographical distribution of the market, and

(ii) from the influence of location on costs and on the evaluation coefficients.

Considerations of economies of large scale may incline one to install a big plant that can serve the largest possible market area.

Nevertheless, as the geographical areas to be served increase, distribution costs from a single location would rise as a result of higher freights; and a point is reached where the advantages of the bigger scale might be overweighed.

Therefore, instead of installing one big plant in one location to cover a wide geographically dispersed market area, two or more medium-size plants may be installed at different locations in the market area. Thus, distribution costs may impose some limitations on the choice of the optimum size of the project (Odufalu, 2000).

4.0 CONCLUSION

Technical analysis is very important in determining the technical requirements of business, location that would be most advantageous, and size of business that would be optimum. Hence the analysis requires the study of the availability, quality, accessibility and price of all the requirements for the business.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to technical analysis in business undertaking.

- Determination of Optimum Location
- Determination of Optimum Size
- Size of Business and the Market
- Business Size and Administrative Capacity
- Business Size and Technique of Production
- Business Size and Location

In the next study unit, we shall discuss defining management team for the operation of a new business venture.

6.0 TUTOR MARKED ASSIGNMENT

Mention and discuss various considerations in technical analysis.

Solution to Self Assessment Exercises

SAE 1. Projects are located near the source of raw material if:

i) Weight at production stage

They have the characteristics of considerable weight loss at the production stage, for example, the initial processing crude material such as crushing of sugar cane or smelting of ores and so on.

ii) Large requirements of fuel

They involve large requirements of fuel. Such projects usually involve a high proportion of weigh loss since the weight of the fuel used does not enter into that of the final product. Most of the industries using large amounts of fuel are those engaged in early stages of processing; for example metallurgy, manufacturing of cement, glass, calcium carbide and synthetic nitrates and so on.

iii) Weights of finished products

The relative weights of materials and finished products are the same, but the procurement cost per kilogram, for example, ginning and baling of cotton, food-preserving industries, and so on.

SAE 2. Factors that influence location of a business project in a particular area include the following:

i) credit facilities,

ii) fiscal incentives

iii) infrastructure facilities

iv) government policy

v) raw materials

SAE 3. The relevant considerations in optimum size of a project are as follows:

i) market demand:-that the market (demand) is very large and it imposes no limitation on the quantity of the product that can be sold.

ii) distribution costs:-that distribution costs are zero.

iii) administrative capacity:- that there is an efficient and adequate administrative capacity to operate the optimum plant size.

iv) type of product:-that the facility produces only one type of product, that is, it is not a multi-product undertaking.

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UNIT 7: DEFINING MANAGEMENT TEAM FOR OPERATION

CONTENT

1.0 INTRDUCTION

The management team and its ability and commitment to the new venture represent an important consideration in running a business venture. The creativity and vision of an entrepreneur may not be actualized without a responsible and responsive management team. The venture would suffer some hiccups in the absence of management team that has to work with the entrepreneur. The entrepreneur is not suppose to be performing all the functions of the organization alone. A management team is needed by the enterprise in order to avoid an untimely demise. The essence of a management team in a venture is the subject of discussion in this study unit

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Explain Developing the Management Team

- Discuss Building the Successful Organization
- Differentiate between Job Description and Job Specification
- Discuss the Role of Board of Directors
- Explain the role Board of Advisors

3.0 MAIN CONTENT

3.1 DEVELOPING THE MANAGEMENT TEAM

Generally, the design of a new organization is simple. Initially, the entrepreneur may find that he or she performs all the functions of the organization alone. Regardless of whether there is one or more individuals involved in the start-up, as the workload increases, the organizational structure will need to expand to include additional employees with defined roles in the organization.

Effective interviewing and hiring procedures will need to be implemented to ensure that new employees will effectively grow and mature with the new venture. A job analysis that may be included in the initial business plan is discussed below.

Regardless of the number of actual personnel involved in running the venture, the organization must identify the major activities required to operate it effectively. The design of the organization will be entrepreneur's formal and explicit indication to the members of the organization as to what is expected of them.
Generally these expectations can be grouped into the following five areas.

1. Planning, measurement, and evaluation schemes: All organization activities should reflect the goals and objectives that underlie the venture's existence. The entrepreneur must spell out how these goals will be achieved (plans), how they will be measured, and how they will be evaluated.
2. Rewards Members of an organization will require rewards in the form of promotions, bonus, praise, and so on. The entrepreneur or other key managers will need to be responsible for these rewards.
3. Selection criteria: The entrepreneur will need to determine a set of guidelines for selecting individuals for each position.
4. Training: Training on or off the job, must be specified. This training may be in the form of formal education or learning skills.
5. The organization's design can be very simple – that is, one in which the entrepreneur performs all the tasks (usually indicative of start-up) – or more complex, in which other employees are hired to perform specific tasks. As the organization becomes larger and more complex, the preceding areas of expectation become more relevant and necessary.

In the initial stage (or stage one), the new venture is operated by basically one person, the entrepreneur. This organizational chart reflects the activities of the firm in production, marketing/sales, and administration. Initially, the entrepreneur may manage all these functions. At this stage, there is no need for sub-managers; the owner deals with everyone involved in all aspects of the operation. In this example, the owner manages production, which may be administrative tasks such as bookkeeping, purchasing, and shipping. Planning, measurement and evaluation, rewards selection criteria, and training would not yet be critical in the organization.

As the business grows and expands, the operations may be more appropriately described by stage two. Here, sub-managers are employed to coordinate, organize, and control various aspects of the business. The marketing manager develops promotion and advertising strategy and coordinates the efforts of the expanding rep organization. The administrative manager then assumes the responsibility for all administrative tasks in the business operation. Here the elements of measurement, evaluation, rewards, selection, and training become apparent.

The next stage which is the third stage exists when the firm achieves a much larger size in terms of operations and strength of employees. The operational activities below each manager in stage two would then be represented by a third level of management such as the managers for quality control, assembly, sales, promotion and advertising, finance and accounting, purchasing, etc.

As the organization expands, the manager or entrepreneur’s decision roles also become critical for an effective organization. As entrepreneur, the manager’s primary concern is to adapt to changes in environment and seek new ideas.

When a new idea is found, the entrepreneur will need to initiate development either under his or her own supervision (stage one figure 7.1) or by delegating the responsibility to someone else in the organization (stage two in figure 7.2).

Figure 7.1:

Stage 1

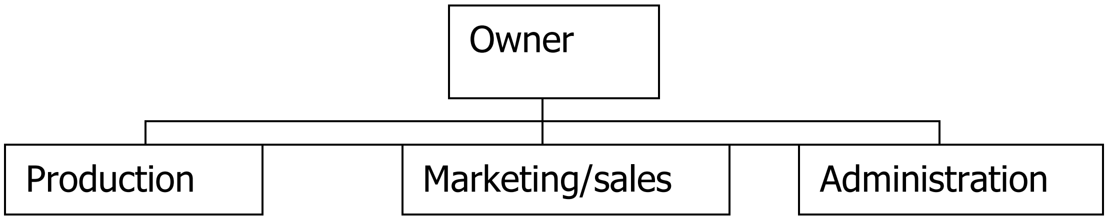
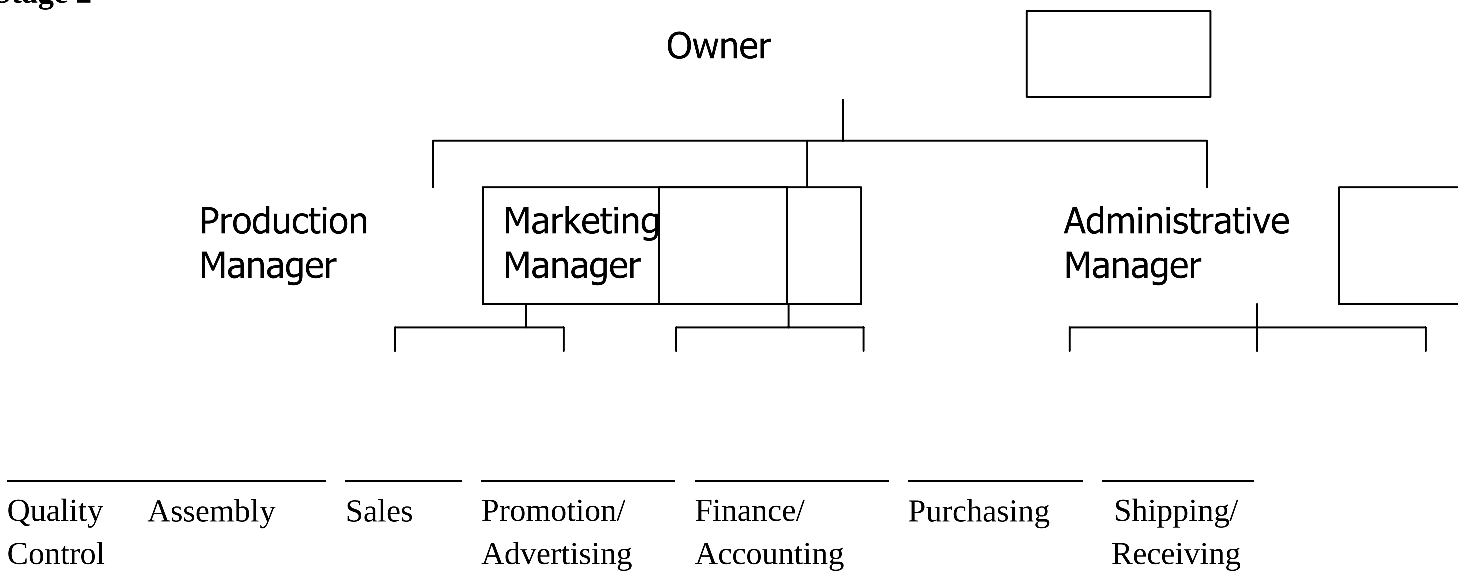


Figure 7.2:

Stage 2



In addition to the role of adaptor, the manager will also need to respond to pressures such as an unsatisfied customer, a supplier reneging on a contract, or a key employee threatening to quit. Much of the entrepreneur’s time in the start-up will be used in contending with emerging operational issues.

There is yet another role for the entrepreneur which is that of allocation of resources. The manager must decide who gets what. This involves the delegation of budgets and responsibilities. You should note that one decision in business can significantly affect other decisions.

The final decision role of the manager is that of negotiation. These are negotiation of contracts, salaries, and prices of raw materials, among others. All these are an integral part of the manager’s job and since he or she can be the only person with appropriate authority, it is an essential aspect of decision making.

Self Assessment Exercise 1:

Discuss the expectations of employees from organizational design.

3.2 BUILDING THE SUCCESSFUL ORGANIZATION

A prelude to writing the organization plan is the preparation of a job analysis by the entrepreneur. The job analysis is meant to serve as a guide in determining employment procedures, training, performance appraisals, compensation programs, and job descriptions and specifications. Essentially, when a very small venture changes, the process becomes more complex.

The starting point for the job analysis is with the tasks or jobs that need to be performed to make the venture viable. The entrepreneur should prepare a list of necessary tasks and skills needed for operations.

The next step to take once a list is completed is for the entrepreneur to determine how many positions would be necessary to accomplish these needs and what type of person or persons would be ideal for such operational requirements. Decisions on where to advertise for employees, how they will be trained, who will train them, how they will be evaluated, and how they will be compensated are important in the early organizational planning for the new venture.

The most important issues in the business plan may be the job descriptions and specifications, which are discussed subsequently below. Many of the other decisions such as employment procedures, training, performance appraisals, benefits, etc can be summarized in a personnel manual that does not need to be part of the business plan.

Nevertheless, the entrepreneur is expected to consider such issues. At some point in operations the entrepreneur may find it necessary to employ a consultant to assist him or her in the preparation of a personnel manual.

3.2.1 Job Description

It is necessary for the entrepreneur clarify the roles of employees by preparing job descriptions. These job descriptions are used to specify the details of the work that is to be performed and any special conditions or skills involved in performing the job.

The issue as to whether these job descriptions should be very detailed or generic has often been a matter of contention. This is moreso especially for a new venture where it is sometimes necessary for individuals to assume more than one role as the need arises. Nevertheless, regardless of which option is chosen by the entrepreneur, the job description should contain information on what tasks are to be performed, the importance of each task, and the time required for each task.

A job description is often employed as a means of communication to candidates for employment what will be expected of them. It should be written in clear, direct, simple language. Figure 7.3 is an example of a job description for a sales manager.FIGURE 7.3 Job Description for a Sales Manager

Required Sales Manager is:

- Responsible for hiring, training coordinating, and supervising all sales representatives, internal and external to the firm.
- Monitor sales by territory in the four-state market area.
- Call on key accounts in market areas once every two weeks to provide sales promotion and merchandising support.
- Prepare annual sales plan for firm, including sales

  forecasts and goals by territory.

In addition, an entrepreneur may also need to list behavioural traits in a job description. For instance, it may be necessary to begin the job description with the activities needed in the job, but then itemizes the behaviours necessary to execute those activities. These behavioural traits can then be considered as questions and used in the interviewing process.

An instance is the issue that a sales manager's position may require him or her to build confidence in others who face rejection from potential clients and have difficulty making appointments. You will appreciate the fact that the only way to determine whether someone fits this requirement will be through careful questioning of candidates in an interview.

It may not be easy for the entrepreneur with no experience to craft the job descriptions. Hence he or she may find it difficulty writing job descriptions. You will recall that the most effective approach when no direct experience exists is to first outline the needs and objectives of the new venture.

The next step is to work backward to determine specific activities that will be needed to achieve these goals and objectives. These activities can then be categorized into distinct areas of responsibility such as marketing, production, administration, etc. From this point the job descriptions may then be prepared.

It is instructive for you to note that as the venture grows, these job descriptions may be upgraded or modified to meet the goals and objectives of the firm.

3.2.2 Job Specification

You will appreciate the fact that job specifications should also be made clear to the prospective employees. Hence the skills and abilities needed to perform the job, which is the job specification must be outlined. Such specification may include the prospective employees' prior experience and education requirements.

FIGURE 7.4 Job Specifications for a Sales Manager

Job specifications of required Sales Manager include:

- <u>3 to 5 years of sales experience</u>
- <u>a Bachelor's degree in Business Administration</u>
- <u>management experience</u>
- <u>effective writing skills</u>
- <u>effective communication skills</u>

It is also imperative for the entrepreneur to stipulate how much travel will be necessary and how effort will be devoted to developing new business. Reporting responsibilities should also be outlined; the sales manager reporting to the owner, executive director, or some other designated individual in the new venture.

This clarification is very imperative towards preventing conflicts, misunderstandings, and communication breakdowns in the organization. The time spent deciding on these specifications and requirements before recruitment will save the entrepreneur from personnel problems in the long run.

Self Assessment Exercise 2:

Differentiate between job specification and job description.

3.3 ROLE OF BOARD OF DIRECTORS & BOARD OF ADVISORS

An entrepreneur may deem it necessary in his or her organization plan to establish a board of directors or board of advisors as the case may be.

3.3.1 Role of Board of Directors

The likely functions of a board of directors are specified below. The board of directors may serve a number of functions and these are as follows:

(1) reviewing operating and capital budgets

(2) developing longer-term strategic plans for growth and expansion

(3) supporting day-to-day activities

(4) resolving conflicts among owners or shareholders,

(5) ensuring the proper use of assets, and

(6) developing a network of information sources for the entrepreneurs.

The above functions may constitute a formal part of the organization, with assigned responsibility to the directors depending on the needs of the new venture. In some business ventures particularly the corporate organizations it is most common to see a board of directors appointed after a venture has been launched.

Nevertheless, there may be provisions to include a board as part of the initial business plan. In such context, the board would represent an important part of the management team and the organization plan when the entrepreneur seeks funding for the new venture.

Essentially, the board of directors could assist the entrepreneur in day-to-day decision making for either financial remuneration or, more likely, for stock or ownership in the business. As the venture grows, the role of the board may change to reflect fundamental issues with the day-to-day decision making left to be determined by the staff. Since a board's involvement has been empirically shown to be positively related to financial performance, the entrepreneurs can only benefit from their existence.

The external board members with diverse backgrounds and expertise can be instrumental in proving objectivity to a new venture. In numerical strength, the board should consist of seven to twelve members with limited terms to allow for continuous infusion of new ideas from different people. The members of the board should be selected on the basis of such factors as willingness to serve, their expertise, and their commitment to supporting the entrepreneur.

The performance of board of directors needs to be regularly evaluated by the entrepreneur. It is the responsibility of the entrepreneur to provide an appraisal of each board member. In order to provide this appraisal, the entrepreneur should have a written description of the responsibilities and expectations of each member.

In general terms, compensation for the board members can be made in form of shares of stock, stock options, or monetary payment. Compensation is an important consideration since it reinforces the obligation of the board members. When the board members are allowed to perform on the basis of volunteerism they would tend to take their role lightly and not provide any value to the entrepreneur.

Self Assessment Exercise 3:

What are the basic functions of a Board of Directors?

3.3.2 The Board of Advisors

A board of advisors, unlike the board of directors, would be more loosely tied to the organization and would serve the venture only in an advisory capacity for some of the functions of the board of directors as mentioned above.

The board of advisors has no legal status, unlike the board of directors, and hence it is not subject to the pressures of litigation with which many directors must be concerned. The board of advisors is likely to meet less frequently or depending on the need to discuss important venture decisions.

Basically a board of advisors is particularly useful in a family business where the board of directors may be made up entirely of family members. Hence the advisors would consist entirely of external people who are in way part of the family.

A family business may form a diverse board of advisors that can include people from diverse background such as an academic, a lawyer, an engineer, a venture capitalist and the owner of a well established business.

The board of advisors can meet every few months or quarterly or whenever the need arises. The entrepreneur may often discover that the board of advisors would often provide a very different perspective since they are not so tied in with everyday business activities. For example, they may object to some growth moves that may not be beneficial to the business in the long run.

4.0 CONCLUSION

It is always necessary for a new business to constitute a viable management team that is capable of nurturing the business to an enviable height. Such management team will be expected to grow the business in leaps and bounds so that the creativity and vision of an entrepreneur may be actualized. A new venture could flutter in its operations in the absence of a responsible and responsive management team that can complement the efforts of the entrepreneur. A new venture also needs a board of directors as well as a board of advisors to complement the efforts of the management team.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to defining management team for operation in business undertaking.

- Developing the Management Team
- Building the Successful Organization
- Job Description
- Job Specification
- Role of Board of Directors
- The Board of Advisors

In the next study unit, we shall discuss market analysis and marketing plan of a new business venture.

6.0 TUTOR MARKED ASSIGNMENT

Discuss the expectations of employees from organizational design.

Solution to Self Assessment Exercises:

SAE 1. The expectations of the employees on organizational design can be grouped into the following areas.

i) Planning, measurement, and evaluation schemes: All organization activities should reflect the goals and objectives that underlie the venture's existence. The entrepreneur must spell out how these goals will be achieved (plans), how they will be measured, and how they will be evaluated.

ii) Rewards Members of an organization will require rewards in the form of promotions, bonus, praise, and so on. The entrepreneur or other key managers will need to be responsible for these rewards.

iii) Selection criteria: The entrepreneur will need to determine a set of guidelines for selecting individuals for each position.

iv) Training: Training on or off the job, must be specified. This training may be in the form of formal education or learning skills.

v) The organization's design can be very simple – that is, one in which the entrepreneur performs all the tasks (usually indicative of start-up) – or more complex, in which other employees are hired to perform specific tasks. As the organization becomes larger and more complex, the preceding areas of expectation become more relevant and necessary.

SAE 2. Job description is used to specify the details of the work that is to be performed and any special conditions or skills involved in performing the job. The job description should contain information on what tasks are to be performed, the importance of each task, and the time required for each task.

Job specification is used to specify the skills and abilities needed to perform a job. Such specification may include the prospective employees' prior experience and education requirements.

SAE 3. The basic functions of a board of directors are as follows:

i) Reviewing operating and capital budgets

ii) Developing longer-term strategic plans for growth and expansion

iii) Supporting day-to-day activities

iv) Resolving conflicts among owners or shareholders,

v) Ensuring the proper use of assets, and

vi) Developing a network of information sources for the entrepreneurs.

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UNIT 8: MARKET ANALYSIS AND MARKETING PLAN

CONTENT

1.0 INTRODUCTION

Marketing is very critical in the operations of any business venture. This is in view of the fact that business operations start and end with marketing. Therefore, it behaves on the entrepreneur to handing the issue of marketing seriously. Hence this study unit is used to discuss the intricacies of marketing in a new venture.

2.0 OBJECTIVES

At the end of this study unit you should be able to:

- Discuss the Market Analysis
- Mention and explain Environmental Factors of Marketing
- Explain the Market Research

- Discuss the Marketing Plan
- List and explain the Characteristics of Marketing Plan
- Mention and discuss Essential Facts for Market Planning
- List and explain Steps in Preparing the Marketing Plan
- Mention and discuss Pitfalls Responsible for Failure of Marketing Plans

3.0 MAIN CONTENT

3.1 MARKETING ENVIRONMENT AND ANALYSIS

Environmental analysis attempts to give the entrepreneur extensive insight as to the current market condition and the possible impact of the external environment. Environmental analysis involves the assessment of external factors that are uncontrollable variables that may impact on the enterprise.

The environmental analysis in business plan plays an important role in convincing potential investors not only that the entrepreneur is aware of these trends but that he or she considers these factors in projecting sales for the new venture. Some of these environmental variables that describe the industry and/or market conditions that could impact the new venture are discussed below. See figure 8.1 for marketing system.

3.1.1 External Environmental Factors

1. The Economy

The entrepreneur should consider trend in the Gross domestic product, unemployment, the geographical area, disposable income, and so on. The data relating to these variables are readily available from the relevant government offices or development agencies.

2. Socio-Culture

An evaluation of socio-cultural changes may involve considerations such as shifts in the population. For example, in terms of demography, there is the impact of the baby boomers or the growing elderly population. Furthermore, shifts in the attitudes, or trends in safety, heath, and nutrition, and concern for the environment may all have an impact on the entrepreneur's market plan. This information can also be found magazines, newspaper, or trade journals.

3. Technology

In most cases advances in technology are difficult to predict. Nevertheless, the entrepreneur should consider potential technologic development determined from resources committed by major industries.

A business in a market that is rapidly changing due to technological development will require the entrepreneur to make careful short-term market decisions. Furthermore, the entrepreneur should be prepared with contingency plans in the face of any new technological developments that may affect his or her product or services.

4. Industry

The demand trend as it relates to the industry is often available from published sources regarding the knowledge of whether the market is growing or declining, the number of new venture. The demand for a new venture’s product or services will require some additional marketing research.

5. Legal

There are many important legal issues to be considered in starting a new venture. The entrepreneur should take into consideration regulation on registration or incorporation. Furthermore, the entrepreneur should also be prepared to contend with any future legislation that may affect the product or services, channels of distribution, prices, or promotion strategy.

Some basic legislation on consumer safety, environmental pollution, taxes on enterprise and sales such as VAT, and other regulations affecting the products and services are legal restrictions that can affect any marketing program. Information on such legislations can often be monitored in newspapers, magazines, journals and publications by trade associations.

6. Competition

In most cases all entrepreneurs generally face potential threats from larger corporations. Hence the entrepreneur must be prepared for the threats of competition, and should be aware of who the competitors are and what their strengths and weaknesses are so that an effective marketing plan can be implemented. Most competitors can be easily identified from newspapers, journals, magazines and publications by trade associations, advertisement, and the yellow pages.

7. Raw materials

The critical assessment of the availability of raw materials may be necessary in situations where the raw materials are limited or access to suppliers is difficult either because they are few or are based in other countries. In most cases trends regarding shortages are often published in various both electronic and print media.

All the above external factors are generally known to be uncontrollable. Nevertheless, as discussed above, an awareness and assessment of these factors by making use of some of the sources identified can provide strong support in developing the appropriate marketing strategy.

Self Assessment Exercise 1:

Mention and discuss the external environmental factors that shape marketing in business.

3.1.2 Internal Environmental Factors

In addition to the above factors, there are internal environmental factors that are more controllable by the entrepreneur but can also affect the operations of an enterprise.

The major internal variables or factors are as follows:

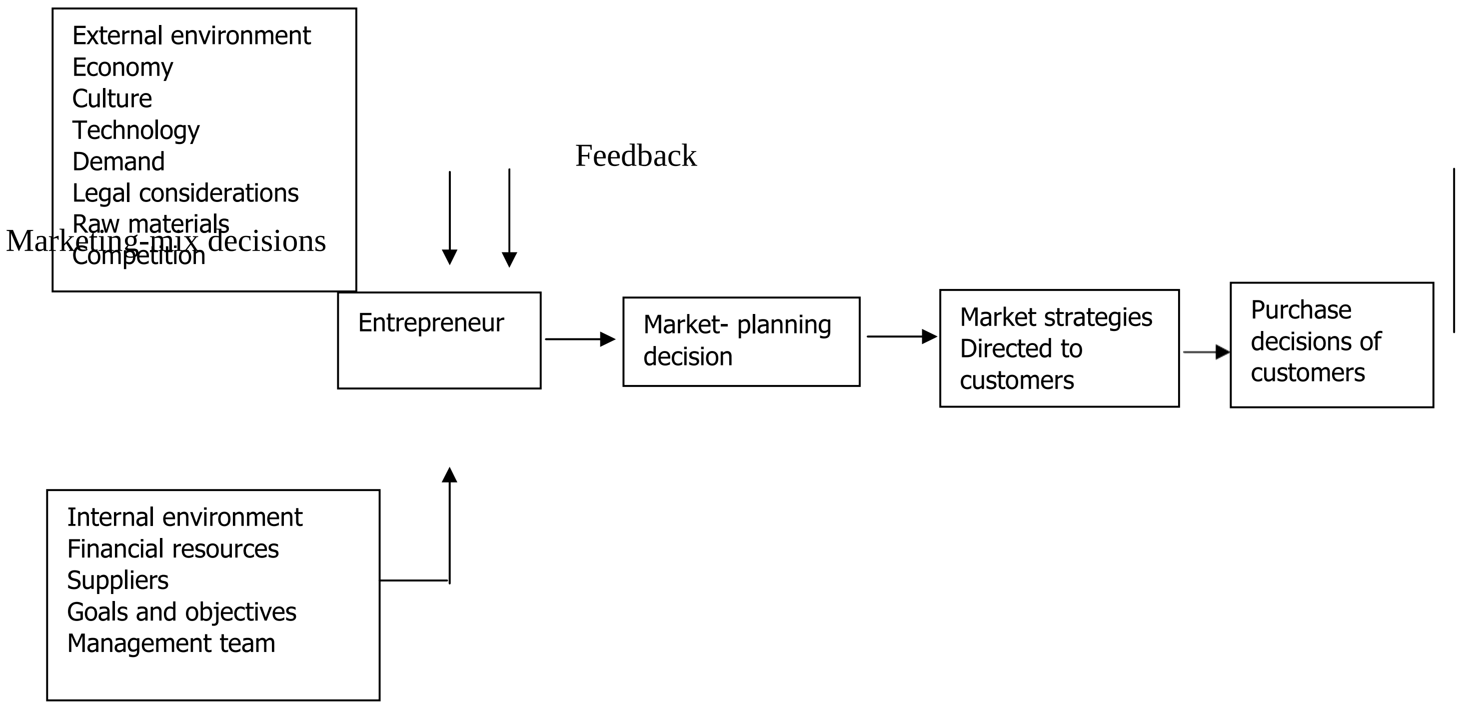
1. **Financial Resources:-** The financial plan, discussed in the next chapter should outline the financial needs for the new venture. Any marketing plan or strategy should consider the availability of financial resources as well as the amount of funds needed to meet the goals and objectives stated in the plan.

2. **Management Team:-** It is extremely important in any organization to make appropriate assignments of responsibility for the implementation of the marketing plan. In some cases the availability of a certain expertise may be uncontrollable (e.g., a shortage of certain types of technical managers). In any event, the entrepreneur must build an effective management team and assign the responsibilities to implement the marketing plan.

3. **Suppliers:-** The suppliers used are generally based on a number of factors such as price, delivery time, quality, management assistance, and so on. In some cases where raw materials are scarce or there are only a few suppliers of a particular raw material or part, the entrepreneur has little control over the decisions, it is important to incorporate these factors into the marketing plan.

4. **Company Mission:-** Every new venture should define the nature of its business. This statement that helps to define the company's mission basically describes the nature of the business and what the entrepreneur hopes to accomplish with that business. This mission statement or business definition will guide the firm through long-term decision making.

Figure 8.1: The Marketing System



Source: Hisrich, R. D. and Peters, M. P. (1998), Entrepreneurship, 4th Ed., Boston: Irwin McGraw-Hill, A Division of The McGraw-Hall Companies, p. 63.

3.2 MARKET ANALYSIS AND RESEARCH

Information on the structure of the market will be very important to the entrepreneur in the early stages of the new venture. Evidence abounds to indicate that the use of market information can affect performance. Therefore, it is necessary for the entrepreneur to consider conducting some level of market research.

Fundamentally, market research begins with a definition of objectives or purpose. This often constitutes the most difficult step since many entrepreneurs lack knowledge or experience in marketing and often doesn’t even know what they want to accomplish from a research study. Paradoxically, this is the very reason for which marketing research can be so meaningful to the entrepreneur.

The logical steps to follow in market analysis are as identified and discussed.

1. Defining the Purpose or Objectives

The ideal way to begin the market research is for the entrepreneur to take time to make a list of the information that will be needed to prepare the marketing plan. The entrepreneur, for instance, may think there is a market for his or her product but is not sure who the customers will be or even if the product is appropriate in its present form.

Hence, one objective would be to ask people what they think of the product or service and if they would buy it, and on this basis collect some background demographics and attitudes of these individuals. This would go a long way to satisfy the objective or problem that the entrepreneur defined above.

Other related objectives may be to determine the following by the entrepreneur:

- The price that potential customers would be willing to pay for the product or service.
- Point at which potential customers would prefer to purchase the product or service.
- Source at which the customer would expect to hear about or learn about such a product or service

2. Gathering Data from Secondary Sources

The most obvious source of information for the entrepreneur is data that already exist, which is the secondary data. This is usually found in many sources such as trade magazines, libraries, government agencies, research institutes, and universities.

A search in a library by the entrepreneur will often reveal published information on the industry, competitors, trends in consumer tastes and preferences, innovations in the market, and even specific information about strategies now being employed by competitors already in the market.

The Internet can also provide extensive information on competitors, the industry, and even provide insightful primary information directly from potential consumers who respond to chat groups. Commercial data may also be available but the cost may be prohibitive to the entrepreneur. Nevertheless, business libraries may subscribe to some of these commercial services.

As a prelude to the use of either primary sources or commercial sources of information, the entrepreneur should exhaust all free secondary sources of information. At the federal level, the National Bureau of Statistics publishes a wide range of statistics on business ventures. Other sources are the State Ministries of Commerce, Chambers of Commerce, Commercial banks, and the print media as well as electronic media.

It is also recommended that the entrepreneur spend time in libraries by contacting catalogs and reference sources to locate articles that have been written about competitors or the industry. These articles, although defined as secondary data, should be scanned to identify the names of individuals who were interviewed, referenced, or even mentioned in the articles.

These individuals can then represent sources to be contacted directly. If their affiliation, telephone number, or address is not given in the article, then the entrepreneur should contact the author(s) of the article to see if they have these affiliations or could even provide some of their personal insights to some of the important market issues.

The entrepreneur can also browse the internet for information posted by many sources on business undertakings. It is advisable that the entrepreneur should exhaust all possible secondary data sources, observation, and networking before beginning any more costly primary data research.

3. Gathering Information from Primary Sources

Information that is generated anew is called the primary data. The generation of the primary data involves a data collection procedure such as observation, networking, interviewing, focus groups, or experimentation, and usually a data collection instrument, such as a questionnaire.

The observation procedure is the simplest approach. This calls for the entrepreneur to observe potential customers and record some aspect of their buying behaviour. The networking procedure, which is more of an informal method to gather primary data from experts in the field, can also be a valuable low-cost method to learn about the market place.

Empirical evidence does indicate that the most successful ventures, based on indices such as growth rate, have been focused on information about competitors, the customer, and the industry, using networking, trade associations, and recent publications.

The less successful ventures were more focused on gathering information on general economic and demographic trends and hence had less of a sense of what was happening in their specific target market. Interviewing or surveying is the most common approach used to gather market information.

Interviewing can be more expensive than observation but is more likely to generate more meaningful information. Interview would have to be conducted personally, by telephone, or through the mail. Each of these methods offers advantages and disadvantages to the entrepreneur and should be evaluated accordingly.

The questionnaire as a data collection instrument to be used by the entrepreneur should include questions specifically designed to fulfill one or more of the objectives

the entrepreneur listed earlier. Questions should be designed so they are clear and concise, do not contain elements of bias against the respondent, and they should be easy to answer by respondents.

A questionnaire instrument should be designed to satisfy the objectives of the entrepreneur, which are to ascertain the need, location, and determination of the most important product or services to offer, and the prices to charge for them.

Since the instrument is important to the entrepreneur in the research process, it is hereby advised that entrepreneurs seek assistance of experts such management consultants if they have no experience in designing questionnaires. Focus groups regarding potential customers, who are invited to participate in a discussion relating to the entrepreneur's research objectives, are of a more informal method for gathering in-depth information.

The focus group discussion is in an informal, open format, which enables the entrepreneur to ascertain certain information. A focus group of a cross-section of people can be constituted by the entrepreneur in order to learn about the tastes and preferences of the consumers in products choice, buying habits, pricing, and other areas of interest.

4. Analyzing and Interpreting the Results

In order to analyze and interpret the generated data, the entrepreneur can tabulate manually, the results or enter them on a computer. Regards of the method used, the results should be evaluated and interpreted in response to the research objectives that were specified in the first step of the research process.

Frequently, summarizing the answers to questions will give some preliminary insights to the information desired. Subsequently, data can be cross-tabulated in order to provide more focused results. For example, the entrepreneur may be interested in comparing the results generated with the questions on the basis of different age groups, sex, occupation, location. The process of continuous fine-tuning can provide valuable insights.

3.3 UNDERSTANDING THE MARKETING PLAN

Usually once the entrepreneur has gathered all the necessary information, the entrepreneur can take time to prepare the marketing plan. The marketing plan, like any other type of plan, may be compared to a thoroughfare used through which the entrepreneur can reach the desired end. See figure 8.2.

The marketing plan is normally designed to provide answers to three basic issues or questions.

1. Where have we been? When used as stand-alone document (operational plan) This would imply some background on the company, its strengths and weaknesses, some background on the competition, and a discussion of the opportunities and threats in the market place. When the marketing plan is integrated as part of the business plan, this segment would focus on some history of the opportunities and threats.

2. Where do we want to go (in short term)? This question primarily addresses the marketing objectives and goals of the new venture in the next twelve months. In the initial plan, the objectives and goals often go beyond the first year because of the need to project profits and cash needs for the first five years.
3. How do we get there? This question discusses the specific marketing strategy that will be implemented, when it will occur, and who will be responsible for the monitoring of activities. The answers to these questions are generally determined from the marketing research carried out before the planning process is begun.

Budgets will also be determined and used in the income and cash flow projections. Management should understand that the marketing plan is a guide for implementing marketing decision making. And as such it is not a generalized, superficial document.

When entrepreneurs do not capture the appropriate time to develop a marketing plan they usually have misunderstood the essence of the marketing plan and what it can and cannot accomplish. The mere organization of the thinking process involved in preparing a marketing plan can be helpful to the entrepreneur.

The above reasoning is because in order to develop the plan, it is necessary to formally document and describe as many marketing details as possible that will be part of the decision process during the next year. This process will enable the entrepreneur to not only understand and recognize the critical issues, but also to be prepared in the event that any change in the environment occurs.

3.3.1 Characteristics of Marketing Plan

It is advisable that the marketing plan be planned to meet certain criteria. Some distinctive characteristics that must be incorporated in an effective marketing plan are as follows. The marketing plan must:

- Provide a strategy for accomplishing the company mission or goal.
- Be based on facts and valid assumptions.
- Provide for the use of existing resources. Allocation of all equipment, financial resources, and human resources must be described.
- Provide an appropriate organization which can be used to implement the plan.
- Provide for continuity so that each annual marketing plan can build on it, successfully meeting longer-term goals and objectives
- Be simple and short. A voluminous plan will be placed in a desk drawer and likely never used. However, the plan should not be so short that details on how to accomplish a goal are excluded
- Specify performance criteria that will be monitored and controlled. For example, the entrepreneur may establish an annual performance criterion of a certain percent of market share in a designated geographic area.

In order to attain effective monitoring and control, certain expectations should be made at given time periods; for example, at the end of three months the business should have a certain percent share of market. In the event that such is not attained, new strategy or performance standards may be established.

The success of the plan may depend on its flexibility. When some changes are necessary, they should be incorporated by including probable scenarios and appropriate responding strategies.

Self Assessment Exercise 2:

What are the basic characteristics of an effective marketing plan?

3.3.2 Essential Facts for Market Planning

For appropriate appreciation of the facts, they are expressed in questions form such as below.

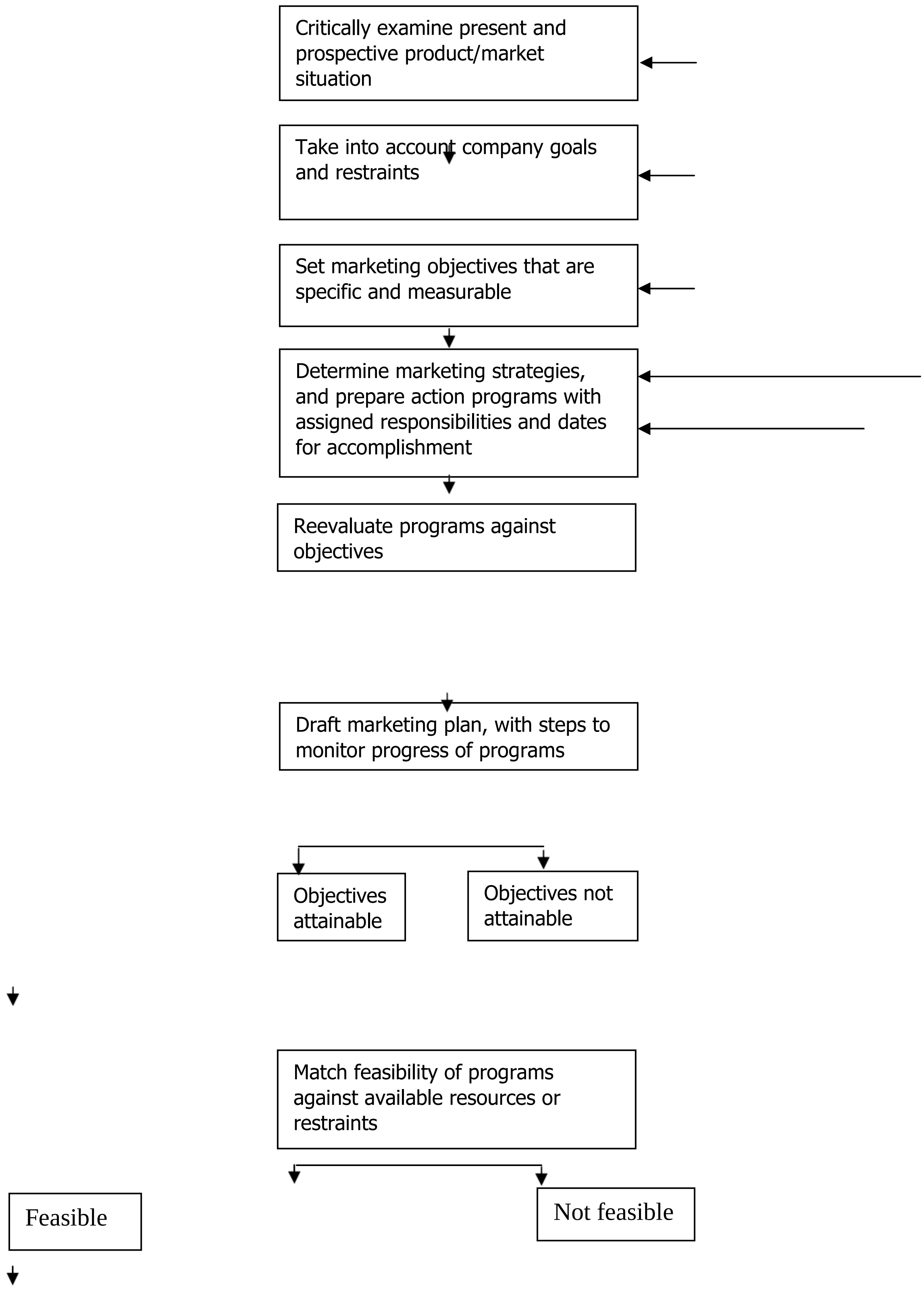
- Who are the users, where are they located, how much do they buy, from whom do they buy, and why?
- How have promotion and advertising been employed and which approach has been more effective?
- What are the pricing changes in the market, who has initiated these changes, and why
- What are the market's attitudes concerning competitive products?
- What channels of distribution supply consumers, and how do they function?
- Who are the competitors, where are they located, what advantages/disadvantages do they have?
- What marketing techniques are used by the most successful competitors? By the least successful?
- What are the overall objectives of the company for the next year and 5 years hence?
- What are the company's strengths? Weaknesses?
- What are one's production capacities by product?

The foregoing discussion is indicative of the fact that the market plan is not intended to be written and then put aside. Essentially therefore, it is intended to be a valuable document, referred to often, and providing guidelines for the entrepreneur in the process of business operation.

You have to recognize the fact that the term marketing plan denotes the significance of marketing. Therefore, it is important to understand the marketing system. The marketing system identifies the major interacting components, both internal and external to the firm that enables the firm to successfully provide products and/or services to the marketplace.

Fundamentally, the environment (external and internal) plays very important role in developing the market plan. Hence, some research on the environmental variables would be a good starting point for the entrepreneur before preparing the market plan. This analysis can begin with data obtained from secondary sources as discussed in the marketing research above. These environment variables have been discussed above.

Figure 8.2: Example of Flow Chart of a Marketing Plan



Submit marketing plan for approval

Source: Hisrich, R. D. and Peters, M. P. (1998), Entrepreneurship, 4th Ed., Boston: Irwin McGraw-Hill, A Division of The McGraw-Hall Companies, p. 67.

3.3.3 Steps in Preparing the Marketing Plan

The various stages involved in preparing the marketing plan are identified and discussed in this section of the unit.

Each of these stages, when followed religiously, will provide the necessary information to formally prepare the marketing plan. Each of the steps is outlined and discussed, incorporating using examples for complete understanding of the necessary information and procedure for preparing the marketing plan. See figure 8.2.

1. Defining the Business Situation

The situation analysis is a review of where we have been. It also considers many of the factors that were defined in the environmental analysis section above. It is to describe past and present business operational conditions.

In order to fully describe the situation analysis, the entrepreneur should provide a review of past performance of the product and the company. If this is a venture, the background will more personal, describing how the product or service was developed and why it was developed; e.g., to satisfy consumer needs. If the plan is being written after the new venture has started up, it would contain information on present market conditions and performance of the company's good and services. Any future opportunities or prospects should also be included in this section of the plan.

Industries analysis should begin with a review of secondary sources at the library. Trade magazines, government publications, or published articles may be useful in determining how attractive the industry is for the entrepreneur. Information on size of market, growth rate, source and availability of suppliers, threat of innovation or new technology, regulations, new entries, and effects of economic conditions should be documented before the marketing strategy is determined.

The above environmental variables will provide much important information in deciding what will be the most effective marketing strategy to be outlined in the marketing plan. The actual short-term marketing decisions in the marketing plan involve the consideration of the product, price, distribution, and promotion. These four factors are referred to as the marketing mix. Each variable is described in detail in figure 8.3 below.

Figure 8.3: Critical Decisions for Elements of Marketing Mix

Marketing Mix Variable	Critical Decisions
Product	Quality of component or materials, style, features, options brand name, packaging, sizes, service availability, and warranties
Price	Quality image, list price, quantity, discounts, allowances for quick payment, credit terms, and payment period
Distribution	Use of wholesalers and/or retailers, type of wholesalers or retailers, how many, length of channel, geographic coverage, inventory, and transportation
Promotion	Media alternatives, message, media budget, role of personal selling, sales promotion (displays, coupons, etc), and media interest in publicity.

Source: Hisrich, R. D. and Peters, M. P. (1998), Entrepreneurship, 4th Ed., Boston: Irwin McGraw-Hill, A Division of The McGraw-Hall Companies, p. 67.

In this first set of the marketing plan, the entrepreneur should also provide a detailed assessment of the competitive environment. Each competitor should be identified, along with its location, size, market share, sales, profits, strengths, and weaknesses.

In evaluating such things as ability to develop new products, management ability, manufacturing capabilities, and financial capabilities, these factors could be rated by the entrepreneur as excellent, good, fair, or poor. The analysis will be used to verify the entrepreneur's marketing strategy.

2. Defining the Target Market/Opportunities and Threats

On the basis of the marketing research, the entrepreneur should have a good idea of who the customers or target market will be. The data on the target market can be very essential in the success of a service venture.

The target market usually comprises one or more segments of the entire market. Therefore, it is important even before beginning the research to understand what market segmentation is besides the determination of the appropriate target market.

Market segmentation is the process of dividing the market into small homogeneous groups. Markets segmentation allows the entrepreneur to more effectively responds to the needs of more homogeneous consumers. Otherwise the entrepreneur would have to identify a product or service that would meet the needs of everyone in the marketplace.

Ideally, the process of segmenting and targeting customers by the entrepreneur should proceed as follows:

1. Decide what general market or industry you wish to pursue.
2. Divide the market into smaller groups based on characteristics of the customers or buying situations.

i. Characteristics of the consumer

(a) Geographic (e.g., state, country, city, region)

(b) Demographic (e.g., age, sex, occupation, education, income, and race).

(c) Psychographic (e.g., personality and lifestyle).

ii. Buying situation

(a) Desired benefits (e.g., product features)

(b) Usage (e.g., rate of use)

(c) Buying conditions (e.g., time available and product purpose).

(d) Awareness of buying intention (e.g., familiarity of product and willingness to buy)

3. Select segment or segments to target.
4. Develop a marketing plan integrating product, price, distribution and promotion.

For instance, in the supply of power inverters, the entrepreneur can segment the market on the basis of users such as:

- Institutions

- Hospitals
- Offices
- Industries
- Households

Basically, the segmentation of market depends on the nature of the product being produced or offered for sale by the entrepreneur.

3. Considering Strengths and Weaknesses of Target Market

It is important for the entrepreneur to consider strengths and weaknesses in the target market. For example, referring to the supply of power inverters, the primary strength is in its high demand due to erratic power supply and it can be used by many electricity consumers and users in institutions, hospitals, offices and industries.

In terms of weaknesses majority of the households could not afford the power inverters, many companies are having steady sources of power supply, and government organizations may not be favourably disposed towards the use of power inverters.

In addition, the firm may not have the funds to produce in large quantity; there is the production capacity which is limited by space and equipment. Furthermore, the new firm lacks a defined distribution system for the product and would have to depend on manufacturers' representatives. Beside, the new firm lacks enough cash to support a heavy promotional effort.

4. Establishing Marketing Goals and Objectives

As a prelude to the marketing strategy decisions, the entrepreneur must establish realistic and specific goals and objectives. These objectives respond to the issues such as market share, level of profits, sales (by territory and region) market penetration, number of distributors, awareness level, new product launching, pricing policy, sales promotion, and advertising support.

For example, the entrepreneur of a new frozen food venture may establish objectives for the first year of operations such as:

- Ten (10) percent market penetration,
- Fifty (50) percent of market sampled,
- Distribution in fifty (50) percent of the market.

All the above goals have been considered modest, reasonable and feasible given the business situation described earlier.

The above goals and objectives merely portrays that they must be quantified and so that they could be measured for control purposes. Nevertheless, not all goals and objectives must be quantified.

Hence it is possible for a firm to establish such goals or objectives as research customer attitudes toward a product, set up a sales training program, improve packaging, change name of product, or find new distributor.

For a new firm, it is a good idea to limit the number of goals or objectives to between six and eight. This is in view of the fact that too many goals make control and monitoring difficult. Apparently, such number of goals should be set to represent key areas to ensure marketing success.

Self Assessment Exercise 3:

Mention the issues on which some goals and objectives may be established for a new firm.

5. Coordination of the Planning Process

For a new venture, the management team must institute some means for coordinating the planning process since many of the members of the team may lack expertise in market planning.

An oversight of proper coordination may present problem in the venture's effective completion. In many cases, the entrepreneur may be the only person involved in preparing the market plan, especially if it is a new venture. This situation may call for consultation with management or marketing experts.

When the entrepreneur is the only one involved in preparing the market plan, coordinating may not be the issue. Nevertheless, the entrepreneur may still lack the understanding and experience for preparing a market plan. In this instance, the entrepreneur should seek help from available sources such as the Small and Medium Enterprises Development Agencies, universities, marketing consultants, and even textbooks.

6. Assigning Responsibility for Implementation

Writing the marketing plan is only the beginning of the marketing process because it is only a means to an end. The plan must be implemented effectively in order to meet all the desired goals and objectives.

Essentially, therefore, a specific person must take the responsibility for implementing each of the strategy and action decision made in the marketing plan. More often than not, the entrepreneur will assume this responsibility since he/she will be interested in the control and monitoring of the venture.

7. Budgeting for the Marketing Strategy

It is also necessary that effective planning decision must also consider the costs involved in the implementation of these decisions. In the event that the entrepreneur has followed the procedure of detailing the strategy and action program to meet the desire goal and objectives, costs would become reasonably clear.

In the event that assumptions are necessary, they should be clearly started so that interested parties (e.g., a banker, a venture-capital firm, etc) who may review the written marketing plan will understand such implications.

The budgeting for marketing action and strategy decision will also be helpful in preparing the details for financial plan. The details on the development of a financial plan are discussed in unit 10 of this study material.

8. Implementation of the Marketing Plan

The marketing plan is normally designed to serve as a commitment by the entrepreneur to a specific strategy. It is not formality that serves as a superficial document to outside financial supporter or suppliers. Essentially, it is meant to be a formal medium for answering some basic issues or questions relating to the operations of the venture. The plan is also a commitment to make adjustments as needed or dictated by market conditions.

9. Monitoring Progress of Marketing Actions

Fundamentally, monitoring of the plan involves keeping tabs on specific result of the marketing effort. For instance, sales data by product, territory, sales representatives, and outlet are few of the specific results that should be monitored. Those operational fundamentals that should be monitored are dependent on the specific goals and objectives incorporated in the marketing plan.

In the event of discovery of any scary deviations from the monitoring process, essentially, the entrepreneur will provide with the opportunity to redirect or modify the existing marketing effort to allow the firm to achieve its initial goals and objectives.

Basically, the entrepreneur may not have the time to consider many alternative plans of action should the initial plan fail. Nevertheless, as you have noted earlier, it is important for the entrepreneur to be flexible and prepared to make adjustments where necessary. Due to environmental upheavals, it is unlikely that any marketing plan will succeed exactly as planned.

3.4 PITFALLS RESPONSIBLE FOR FAILURE OF MARKETING PLANS

Marketing plans can become ineffective and fail in meeting marketing goals for different reasons. Infact, failure may also be considered a matter of degree since some goals may become realizable while others may become totally unachievable.

The failure of the overall plan will be evaluated by management and may depend on the simple solvency of the organization. Some of the reasons for failure can be ameliorated if the entrepreneur is careful in preparing the marketing plan.

Some of the basic reasons for failure of marketing plan which can be controlled by the entrepreneur are as follows:

1. Lack of Real Plan

The marketing plan is superficial and lacks detail and substance, especially regarding goals and objectives.

2. Lack of Adequate Situation Analysis

It is invaluable to know where you are and where you have been, before deciding where you want to go. Careful analysis of the environment can result in reasonable goals and objectives.

3. Unrealistic Goals

This generally results because of lack of understanding of the situation. It arises when spurious goals and objectives are unachievable. Such goals and objectives are bound to fail because a new business should restrict to only few and realistic targets.

4. Unanticipated Competition

This refers to unanticipated competitive moves, product deficiencies, and acts of God-with a good situation analysis, as well as an effective monitoring process, competitive decisions can be assessed and predicted with some degree of accuracy.

5. Deficiencies in the Product

Deficiencies in the product often result from rushing the product to the market. Such product will be rejected by the consumers since the deficiencies will not allow the product to meet the expectation of the users.

6. Environmental Adversity

Environmental adversities such as an oil spill, flood, hurricane, or war, on which the entrepreneur has no control can render whatever modest goals and objectives unachievable.

7. Lack of Proper Monitoring

The absence of proper monitoring of the progress of marketing actions can result in abnormal deviations in the expected results and hence there will be failure in the whole plan.

8. Ambitious Plans

The establishment of ambitious plans particularly in market penetration, and by implication the anticipated returns, can result in commitment of large quantum of funds and yet the sales volume in the initial years will be anything that can cover the costs of operations.

9. Lackluster Attitude to Implementation

Lackluster attitude towards implementation of the marketing plan on the part of the entrepreneur can make the plan to fail. When there is less commitment by the entrepreneur to a specific strategy the marketing plan can fail woefully.

10. Inappropriate Budgeting for Implementation

When adequate funds are not budgeted for the implementation of the chosen marketing strategy the marketing plan is bound to fail. In essence, ineffective planning decision can result in inappropriate consideration of the costs involved in the implementation of marketing decisions. Hence implementation of marketing plans to meet the desire goal and objectives will be jeopardized.

4.0 CONCLUSION

In any business operations marketing plays critical role because all the operations revolve around marketing. Market analysis is very vital in assessing the marketing environment in which the business will operate.

Relatedly, the marketing plan is designed towards answering some basic issues relating to the operations of the venture. Hence the plan is needed to make adjustments as market conditions dictate. In the process of designing marketing plans there are some fundamental pitfalls to avoid in order towards ensuring the achievement of operational goals and objectives.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to market analysis and marketing plan:

- Marketing environment and analysis
- Market Analysis and Research
- Understanding the Marketing Plan
- Characteristics of Marketing Plan
- Essential Facts & Steps in Preparing Market Planning
- Pitfalls Responsible for Failure of Marketing Plans

In the next study unit, we shall discuss defining marketing strategies of a new business venture.

6.0 TUTOR MARKED ASSIGNMENT

Mention and discuss the various pitfalls that must be avoided in marketing plan.

Solution to Self Assessment Exercises:

SAE 1. The external environmental factors that shape marketing in business are as follows.

i. The Economy

The entrepreneur should consider trend in the Gross domestic product, unemployment, the geographical area, disposable income, and so on. The data relating to these variables are readily available from the relevant government offices or development agencies.

ii. Socio-Culture

An evaluation of socio-cultural changes may involve considerations such as shifts in the population. For example, in terms of demography, there is the impact of the baby boomers or the growing elderly population. Furthermore, shifts in the attitudes, or trends in safety, heath, and nutrition, and concern for the environment may all have an impact on the entrepreneur’s market plan. This information can also be found magazines, newspaper, or trade journals.

iii. Technology

In most cases advances in technology are difficult to predict. Nevertheless, the entrepreneur should consider potential technologic development determined from resources committed by major industries.

A business in a market that is rapidly changing due to technological development will require the entrepreneur to make careful short-term market decisions. Furthermore, the entrepreneur should be prepared with contingency plans in the face of any new technological developments that may affect his or her product or services.

iv. Industry

The demand trend as it relates to the industry is often available from published sources regarding the knowledge of whether the market is growing or declining, the number of new venture. The demand for a new venture's product or services will require some additional marketing research.

v. Legal

There are many important legal issues to be considered in starting a new venture. The entrepreneur should take into consideration regulation on registration or incorporation. Furthermore, the entrepreneur should also be prepared to contend with any future legislation that may affect the product or services, channels of distribution, prices, or promotion strategy.

Some basic legislation on consumer safety, environmental pollution, taxes on enterprise and sales such as value added tax (VAT), and other regulations affecting the products and services are legal restrictions that can affect any marketing program. Information on such legislations can often be monitored in newspapers, magazines, journals and publications by trade associations.

vi. Competition

In most cases all entrepreneurs generally face potential threats from larger corporations. Hence the entrepreneur must be prepared for the threats of competition, and should be aware of who the competitors are and what their strengths and weaknesses are so that an effective marketing plan can be implemented. Most competitors can be easily identified from newspapers, journals, magazines and publications by trade associations, advertisement, and the yellow pages.

vii. Raw materials

The critical assessment of the availability of raw materials may be necessary in situations where the raw materials are limited or access to suppliers is difficult either because they are few or are based in other countries. In most cases trends regarding shortages are often published in various both electronic and print media.

SAE 2. The basic characteristics of an effective marketing plan are as follows:

i. Provide a strategy for accomplishing the company mission or goal.

ii. Be based on facts and valid assumptions.

iii. Provide for the use of existing resources. Allocation of all equipment, financial resources, and human resources must be described.

iv. Provide an appropriate organization which can be used to implement the plan.

v. Provide for continuity so that each annual marketing plan can build on it, successfully meeting longer-term goals and objectives

vi. Be simple and short. A voluminous plan will be placed in a desk drawer and likely never used. However, the plan should not be so short that details on how to accomplish a goal are excluded

vii. Specify performance criteria that will be monitored and controlled. For example, the entrepreneur may establish an annual performance criterion of a certain percent of market share in a designated geographic area.

SAE 3. The issues on which some goals and objectives may be established for a new firm are as follows.

- Market share
- Level of profits
- Sales volume/turnover
- Market penetration
- Number of distributors
- Awareness level
- New product launching
- Pricing policy
- Sales promotion, and
- Advertising support.

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MODULE 3

UNIT 9: DEFINING MARKETING STRATEGIES

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Marketing Strategies and Action Plans

3.2 Product or service:

3.3 Pricing

3.4 Distribution

3.5 Promotion

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References and Further Reading

1.0 INTRODUCTION

You will recall that in the preceding we discussed market analysis and marketing plan. Defining the marketing strategies is built on assessment of marketing environment and by extension the formulation of relevant operational goals and objectives. Hence on the strength of such operational goals and objectives the entrepreneur proceeds to develop the marketing strategies and action plans to achieve them. Therefore, developing marketing strategies and action plans for operations is the subject matter of discussion in this study unit.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- Explain marketing strategies and action plans
- Mention and discuss areas of distinction to consider in product

- List and explain factors to consider in fixing price for a new product
- Identify and discuss various media for advertising product or service
- Mention and explain elements of promotion in marketing.

3.0 MAIN CONTENT

3.1 MARKETING STRATEGY AND ACTION PROGRAMS

On the basis of the marketing goals and objectives, the entrepreneur can commence to develop the marketing strategy and action plan towards achieving them. These strategy and action decisions are normally designed to respond to the issue of how the business gets to the desired state of operations. Basically, this decision defines the marketing mix variables to be adopted by the entrepreneur.

The marketing strategies are the means, methods, or plans that will be used by the entrepreneur to produce appropriate product or service for the business. Furthermore, the appropriate pricing for the product or service is also considered in formulation of marketing strategies

The entrepreneur should also understand that the prospective consumers for the product or service of the new business cannot get it unless it is taken to the doorsteps or vicinity in various locations. Hence the issue of distribution is also considered in the formulation of the marketing strategies.

The prelude to the distribution of the product or service of the business is its promotion in order to create awareness, in the minds of prospective consumers, about the existence of such product or service. Hence promotion is very critical in formulation of marketing strategies.

In the formulation of promotion strategies such relevant variables as sales promotion, advertising, personal selling, and publicity are considered in terms of the applicable strategies for them since they are the integral aspects of promotion in marketing.

Some possible decisions that would be involved in each of the marketing mix variables are discussed in the sections below.

3.2 PRODUCT OR SERVICE:

This constituent of the marketing mix involves a description of the product or service to be produced or marketed in the new venture. This product or service characterization may consider more than the physical characteristics.

For example, a company's product is personal computers, which may not distinctive from many other existing competitors' computers. Nevertheless, what make the difference in such PCs being offered making the computers distinctive is the fact that they may be assembled from off the shell components and are marketed with direct marketing techniques promising quick delivery and low prices.

Hence, the computers are more than their physical components. In essence, the areas of distinction in such product are as follows:

- Packaging,
- The brand name
- The price
- Warranty
- Image
- After-sales Service
- Delivery time
- Features, and
- Style.

In consideration of market strategy, the entrepreneur will need to give cognizance of all or some of the above issues relating to products. Above all, the entrepreneur will also need to keep in mind the basic goal of satisfying customer needs.

Self Assessment Exercise 1:

What are the areas of distinction that an entrepreneur can introduce in a product?

3.3 PRICING

One of the more difficult decisions to consider in respect of the marketing strategies is determination of the appropriate price for the product or service.

There are fundamental factors to consider in fixing appropriate price for a new product such as identified below:

- The product quality
- Nature of the components (expensive or cheap)

- Costs of production or procurement
- Cost of promotion
- Freight or transportation cost
- Desired mark-ups
- Competitors' prices
- Discounts involved
- Cost of service
- Cost of distribution

Furthermore, the entrepreneur will consider pricing strategies such as penetration strategy and scheme-the-cream strategy in setting price for the product. The choice of the entrepreneur in pricing strategy will affect the final price at which the product will be offered to the consumers.

The procedure of estimating price is often associated with the difficult task of estimating costs. This is because they are often reflected in demand, which in itself is difficult to project. Nevertheless, marketing research can often assist the entrepreneur in determining a reasonable price that consumer would be willing to pay.

Self Assessment Exercise 2:

Mention the various factors to consider in fixing appropriate price for a new product.

3.4 DISTRIBUTION

The distribution of product normally provides utility to the consumers. By implication, distribution makes the product to be available where it is needed, at the time it is needed, and at the right quantity. Hence, distribution makes a product convenient to purchase when it is needed.

Distribution as a marketing variable must also be consistent with other marketing mix variables. For example, a high-quality product will not only carry a high price, but it also should be distributed in outlets that have a quality image and at strategic places that can attract the attention of the target consumers.

There are many options for the entrepreneur to consider in distributing the product. Issues such as type of channel, number of intermediaries, and location of channel members should be described in this section of the marketing plan. In a new venture, it may be appropriate to limit the channels to a few ones, because of the cost implications.

In recent time, direct mail or telemarketing as a means of distributing the product or services has become commonplace. Such means of reaching the target consumers is very applicable to some products.

The recent success of direct-marketing techniques can be attributed to changes in composition of household. Furthermore, the growth in dual-income families, the increased interest in time saving, and the acceptance of this method has all contributed significantly to its success.

In addition, working class men and women have also grown in importance as direct-marketing customers. Marriages are occurring later and single ladies are achieving successful professional careers that with them good salaries and an interest in time saving ways to shop for such products, to name but just a few.

In the Western world, mail order catalog shopping have been one of the fastest growing segments of retailing in the past few years and has led to many successful mail-order businesses. The catalogs business appeals to unique market segments and tries to meet their needs with fast response, good prices, and quality merchandise.

Empirical evidence portrays that direct mail marketing is one of the simplest and lowest in entry cost for an entrepreneur to launch for a product. In order to run a mail marketing the entrepreneur needs a good mailing list, a catalog or a brochure with products described, and a toll-free number for customers.

The growth and expansion in computer technology has made mailing lists not only inexpensive, but they can be directed to a very narrowing defined target market. Moreso, mailing lists can be easily purchased at very reasonable costs from mailing list brokers, who are listed in the yellow pages.

The problem is that direct-marketing techniques are not guarantee for success. Therefore, the entrepreneur should evaluate all possible options for distribution before making a decision in the marketing plan. Essentially, both marketing research and networking among business associates and friends can often provide helpful insights in direct mailing marketing.

3.5 PROMOTION

It is usually necessary for the entrepreneur to employ some promotion strategies to inform potential consumers about the product's availability or to educate the customer. In this regards, the entrepreneur can use advertising media such as print, radio, or television to promote the availability of his product.

The use of electronic medium can be too expensive unless the entrepreneur considers the international market viable and therefore, makes use of cable television a viable outlet. A small service or retail company such as a gift store may find that using local cable stations is the most cost-effective method to reach customers.

Business such as larger markets can be reached using direct mail, trade magazines, or newspaper for the promotion of their products or services. It is advisable that the entrepreneur considers carefully the evaluation of each alternative medium. The entrepreneur should take into cognizance not just costs but the effectiveness of the medium in meeting the market objectives in the marketing plan.

The entrepreneur can also make use of publicity as a means of introducing his product or service to the market. The entrepreneur can formulate unique or creative marketing ideas, which are often of special interest to the media to promote his product or service.

Both national and local newspapers, trade magazines and periodicals can be employed to write articles about new start-ups and their products. A public relations strategy that prepares news releases for these media can often result in defined advertising for products or services. The entrepreneur should consider these promotional outlets in conjunction with any other promotional strategies in promoting methods.

Essentially, therefore, the various elements of promotion involve the use of advertising, sales promotion, personal selling, and publicity.

Self Assessment Exercise 3:

Mention the various media through you can promote availability of a new product or service.

4.0 CONCLUSION

Establishing viable marketing strategies for a new business follows the market analysis and marketing plan. This is because formulation of such strategies depends on assessment of marketing environment as well as formulation of relevant operational goals and objectives. Hence marketing strategies and action plans are usually developed to pursue and achieve them. Therefore, strategies are normally developed for the product or service being offered by the business, their pricing, distribution, and promotion.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to defining marketing strategies.

- Marketing Strategy and Action Programs
- Product or service:
- Pricing
- Distribution
- Promotion

In the next study unit, we shall discuss the issue of business plan implementation.

6.0 TUTOR MARKED ASSIGNMENT

Mention and discuss the various marketing mix variables

Solution to Self Assessment Exercises

SAE 1. The areas of distinction that an entrepreneur can introduce in a product are as follows:

- Packaging,
- The brand name
- The price
- Warranty
- Image
- After-sales Service
- Delivery time
- Features, and
- Style.

SAE 2. The various factors to consider in fixing appropriate price for a new product such as identified below:

- The product quality
- Nature of the components (expensive or cheap)

- Costs of production or procurement
- Cost of promotion
- Freight or transportation cost
- Desired mark-ups
- Competitors’ prices
- Discounts involved
- Cost of service
- Cost of distribution

SAE 3. The various media through you can promote availability of a new product or service are as follows.

- Newspapers
- Trade magazines
- Periodicals
- Radio
- Television
- Direct mail
- Trade Fairs
- Exhibitions
- Cultural Festivals
- Anniversary Celebrations

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UNIT 10: BUSINESS PLAN IMPLEMENTATION

CONTENT

1.0 INTRODUCTION

You will recall that the preceding study unit has been used to discuss the preparation of a business plan of business proposal. The preparation of the business plan is not an end but only a means to an end. The end to the preparation of business plan is its implementation, which involves putting the plans in operations. Therefore, this study unit is used to discuss the implementation of business plans.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- Outline the essential areas of a business plan
- Explain the implementation of a business plan
- Explain measurement of a plan progress
- Mention ways of avoiding failure of business plans

3.0 MAIN CONTENT

3.1 REVIEW OF A BUSINESS PLAN

You will recall that business plan as a formal planning process in starting a new business venture is essential towards establishing a viable and profitable entity. Hence business plan focuses on the entire venture and is to describe all the elements involved in starting a new business venture.

A business plan incorporates the following areas in business operations:

1. The Industry

This is the overview of the industry in which the business will operate industry trends, industry turnover and likely market share of the business in the industry.

2. Market Analysis

This is the target market of the business, geographical location, and demography of the target market, their needs and plan to meet them.

3. Competition in the Industry

This involves the number of competitors, their competitive advantages and the venture's strategies in meeting such challenges.

4. Marketing Strategies

This refers to a comprehensive analysis of the venture's sales strategies, pricing policies, promotion strategies, and peculiar advantages of the venture's products/services.

5. Financial Plan

This has to do with detailing of financing requirements, source of financing the ventures, owner's contribution, and financial projections.

6. Management Plan

This is a comprehensive plan on management resources of the venture; management team, external resources or outsourced personnel, emoluments and welfare packages for motivation.

7. Operating Plan

This describes the physical location of the business, strength of employees needed for the venture, facilities and equipment, inventory requirements and suppliers, production method, and manufacturing process.

Self Assessment Exercise 1:

Outline and explain the essential areas of a business plan.

3.2 IMPLEMENTATION OF BUSINESS PLAN

The business plan is meant to guide the entrepreneur through the initial years of operations. It is important that the implementation of the strategy incorporates control points to ascertain progress and to initiate contingency plans if necessary.

Ample evidence abounds to suggest that there has been a tendency among entrepreneurs to avoid engaging in planning. The usual reason adduced for such oversight is that planning is dull or boring and is an issue reserved only for the large companies. This sounds a convincing excuse but some entrepreneurs do not actually appreciate the strategic importance of business planning.

Planning as it were is an important part of any business operation. In the absence of good planning, the entrepreneur is likely to pay an enormous price. All the entrepreneur has to do is consider the fact that planning is done by all those in business such as suppliers, customers, competitors, and bankers etc. Hence business planning is important for the entrepreneur.

It is also important to realize that good planning enables the employees to appreciate and understand the company's goals and how they are expected to perform in their jobs, so that the implementation of operational plans becomes very seamless.

Bright planning is not a complicated or unattainable exercise for the inexperienced entrepreneur. A proper commitment and support from many other people such as outside resources and consultants can enable the entrepreneur to prepare an effective business plan.

Furthermore, the entrepreneur can augment effective implementation of the business plan by developing a schedule to measure progress and to institute contingency plans.

3.3 ASSESSING THE PLAN PROGRESS

At the initial stage of the venture, the entrepreneur is expected to determine the point at which decisions should be made as to whether the goals or objectives are assessed. Classically, projections in business plans made for a period of one year. Nevertheless, the entrepreneur has the responsibility to be assessing the progress of his or her on monthly, quarterly and half-yearly basis.

This will enable the entrepreneur to ascertain whether or not the plan has been successfully achieved. Hence on frequent basis the entrepreneur should assess the progress of the plan by verifying the:

- profit and loss statement
- cash flow projections
- information on inventory
- data on production
- product quality
- volume of sales
- collection of accounts receivable
- disbursements for the previous month.

This form of feedback is valuable in keeping the employees abreast of current information on periodic basis with which to correct any major deviations from the goals and objectives outlined in business plan.

The following constitute the analysis of the necessary control measures for assessing the progress of a business plan.

1. **Inventory Control:-** by controlling inventory, the firm can ensure maximum service to the customer. The faster the firm gets back its investment in raw materials and finished goods, the faster that capital can be reinvested to meet additional customer need.
2. **Production Control**:- Compare the cost figures estimated in the business plan against day-to-day operation costs. This will help to control machine time, worker hours, process time, delay time, and downtime cost.
3. **Quality Control:-** This will depend on the type of production system but is designed to make sure that the product performs satisfactorily.
4. **Sales Control Information**:- on units, dollars, specific products sold, price of sales, meeting of delivery dates, and credit terms are all useful to get a good perspective of the sales of the new venture. In addition, an effective collection system for accounts receivable should be set up to avoid aging of

accounts and bad debts.

5. **Disbursements:-** The new venture should be control the amount of money paid out. All bills should be reviewed to determine how much is being disbursed and for what purpose.

Self Assessment Exercise 2:

Mention and explain the necessary measures for assessing the progress of a business plan.

3.4 AVOIDING FAILURE OF BUSINESS PLANS

Generally there are some avoidable pitfalls in business plans which can render it ineffective. Such avoidable pitfalls in poorly prepared business plan are as follows:

- Goals set by entrepreneur are unreasonable
- Goals are not measurable
- The entrepreneur has not made a total commitment to the business or to the family
- The entrepreneur has no experience in the planned business
- The entrepreneur has no sense of potential threats or weakness to the business
- No customer need was established for the proposed product or service.

It is instructive to note that goal setting requires that the entrepreneur be well- informed about the type of business and the competitive environment in which his venture operates. Generally, it is necessary for goals should be specific and not so ambiguous as to lack any basis of control. For example, an entrepreneur may set objectives on a specific market share, units sold, or revenue from turnover. These goals are measurable and can be monitored over time.

In addition, the entrepreneur and his or her employees must make a total commitment to the business in order to be able to meet the demands of a new venture. For example, it is difficult to operate a new venture on a part-time basis while still holding onto a full-time position in the entity. It is also difficult to operate a business without an understanding of the employees as to the time and resources that will be needed for the venture to succeed.

The providers of funds or investors will not be favourably disposed towards a venture that does not have full-time commitment from the entrepreneur. Furthermore, loan benefactors or lenders or investors will expect the entrepreneur to make a significant financial commitment to the business.

Generally, lack of experience on the part of the entrepreneur will result in failure unless the entrepreneur can either attain the necessary knowledge or team up with an experienced hand. For example, an entrepreneur trying to start restaurant business without any experience or knowledge of the business would have to work with an experienced caterer.

In addition, the entrepreneur should also assess and understand customer needs before preparing the business plan. Customer needs can be identified from direct experience, testimonies from customers, or from marketing research. A clear understanding of these needs and how the entrepreneur's business will effectively meet them becomes imperative to the success of the new venture.

Self Assessment Exercise 3:

What are the areas of pitfalls that can make a business plan fail?

4.0 CONCLUSION

You have understood from the foregoing discussion that preparation of a business plan is not an end in itself per se but implementation of such plan is called for. The implementation of business plan is imperative in the process of establishing a venture since the implementation is necessary in putting it on a good stead towards achieving the venture's purpose. In the process of plan implementation, as you have observed from above analysis, certain measures are necessary in monitoring and evaluating the plan progress. Above all, some measures must be instituted towards obliterating pitfalls which can cause failure in the process of implementation of the business plan.

5.0 SUMMARY

In this study unit, we have discussed the following topics they relate to implementation of the business plan.

- Review of a Business Plan
- Implementation of Business Plan
- Measuring Plan Progress
- Avoiding Failure of Business Plans

In the next study unit, we shall discuss the issue of financial analysis.

6.0 TUTOR MARKED ASSIGNMENT

List and discuss the necessary measures for assessing progress in the process of implementation of a business plan.

Solution to Self Assessment Exercises

SAE 1. The essential areas of a business plan are as follows:

i. The Industry

This is the overview of the industry in which the business will operate, industry trends, industry turnover and likely market share of the business in the industry.

ii. Market Analysis

This is the target market of the business, geographical location, and demography of the target market, their needs and plan to meet them.

iii. Competition in the Industry

This involves the number of competitors, their competitive advantages and the venture's strategies in meeting such challenges.

iv. Marketing Strategies

This refers to a comprehensive analysis of the venture's sales strategies, pricing policies, promotion strategies, and peculiar advantages of the venture's products/services.

v. Financial Plan

This has to do with detailing of financing requirements, source of financing the ventures, owner's contribution, and financial projections.

vi. Management Plan

This is a comprehensive plan on management resources of the venture; management team, external resources or outsourced personnel, emoluments and welfare packages for motivation.

vii. Operating Plan

This describes the physical location of the business, strength of employees needed for the venture, facilities and equipment, inventory requirements and suppliers, production method, and manufacturing process.

SAE 2. The necessary measures for assessing the progress of a business plan are as follows:

i. Inventory Control:- by controlling inventory, the firm can ensure maximum service to the customer. The faster the firm gets back its investment in raw materials and finished goods, the faster that capital can be reinvested to meet additional customer need.
ii. Production Control:- Compare the cost figures estimated in the business plan against day-to-day operation costs. This will help to control machine time, worker hours, process time, delay time, and downtime cost.
iii. Quality Control:- This will depend on the type of production system but is designed to make sure that the product performs satisfactorily.
iv. Sales Control Information:- on units, dollars, specific products sold, price of sales, meeting of delivery dates, and credit terms are all useful to get a good perspective of the sales of the new venture. In addition, an effective collection system for accounts receivable should be set up to avoid aging of accounts and bad debts.
v. Disbursements:- The new venture should be control the amount of money paid out. All bills should be reviewed to determine how much is being disbursed and for what purpose.

SAE 3. The areas of pitfalls that can make a business plan fail are as follows:

- Goals set by entrepreneur are unreasonable
- Goals are not measurable
- The entrepreneur has not made a total commitment to the business or to the family
- The entrepreneur has no experience in the planned business
- The entrepreneur has no sense of potential threats or weakness to the business
- No customer need was established for the proposed product or service.

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UNIT 11: FINANCIAL ANALYSIS

CONTENT

1.0 INTRODUCTION

It is always very critical for the entrepreneur to assess the financial implications of the new business before embarking on to operations. The financial evaluation calls for consideration of operational cost and probable accruable revenue from operations in order to convince himself and interested parties that the business is a profitable venture. Hence the discussion in this study unit revolves around financial analysis of a new business venture.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- Explain and prepare an operating and capital budget
- Discuss and prepare pro forma income statements
- Explain and prepare a pro forma cash flow
- Discuss and prepare a pro forma balance sheet

- Explain and prepare pro forma sources and uses of funds
- Discuss break-even analysis

3.0 MAIN CONTENT

3.1 OPERATING AND CAPITAL BUDGET

In financial analysis, it is necessary for the entrepreneur to prepare operating and capital budgets before developing the pro forma income statements.

A sole proprietor is normally responsible for the budgeting decisions. On the other hand, in the case of a partnership, or where employees exist, the initial budgeting process may begin with one of these individuals depending on his or her role in the venture.

For example, a sales budget may be prepared by a sales manager, a manufacturing budget by the production manager, and so on. The final determination of the relevant budgets for operation will ultimately rest with the owners or entrepreneurs.

The entrepreneur is advised to first develop a sales budget that is an estimate of the expected volume of sales by month for the purpose of the preparation of the pro forma income statement. From the sales forecasts the entrepreneur will then determine the costs of the monthly sales.

In a manufacturing venture the entrepreneur is advised to compare the cost of producing the products internally or sub-contracting them to another manufacturer. An item to be included will also be the estimated ending inventory needed as a buffer stock against possible fluctuations in demand and the costs of direct labour and materials.

An example of a simple projection for a production or manufacturing budget for the first three months of a business operation is given in Figure 11.1 below. The example provides an important basis for projecting cash flow for the cost of goods produced, which includes units in inventory.

The important deduction from the budget is the actual production required each month and the inventory that is necessary to allow for sudden changes in demand. An important conjecture is that the production required in the month of January is greater than the projected sales because of the need to retain three units in inventory.

In the month of February, the actual production required is less than projected sales since the inventory needs are less than in the first month. Hence the budget reflects seasonal demand that can increase demand and inventory.

Basically, the pro forma income statement will only reflect the actual costs of goods as a direct expense in the production process. Therefore, this budget can be a very valuable tool to access cash needs in those business ventures in which high levels of inventory are necessary or where demand fluctuates significantly due to dictates of seasonality.

Figure 11.1:

Projected Manufacturing Budget (First 3 Months) in Units

	Jan	Feb	Mar
Projected sales (units)	60	70	80
Add: Desired ending inventory	3	2	6
Available for sale	63	72	86
Less: Beginning inventory	0	3	2
Total production required	63	69	84

The above manufacturing budget is highly simplified because it is meant to just throw some light into the preparation of such a budget. Hence it can be very complex and tasking.

The prelude to the estimation of operating costs is the preparation of projected capital budget. Therefore, after the preparation of the sales budget, the entrepreneur can then focus on operating costs. The first step is to prepare a list of fixed expenses to be incurred regardless of sales volume. These include expenses such as rent, rates, utilities, salaries, interest, depreciation and insurance.

The anticipation of when new employees will be employed or new storage space can be added will then be reflected in the fixed expense budget. The next step is for the entrepreneur to ascertain variable expenses, which may change from month to month, depending considerations such as sales volume, seasonality, or opportunities for new business.

From the consideration of these operating expenses item by item and with input from the appropriate employees, the entrepreneur can more effectively develop the pro forma statements as discussed in the subsequent section below. Essentially, the capital budgets are intended to provide a basis for evaluating expenditures that will impact the business for a period of more than one year.

Such operational expenditures include expenditures for new equipment, vehicles, computers, or even a new facility. The entrepreneur may also consider evaluating the costs of make or buy decisions in manufacturing or a comparison of leasing, buying fairly used equipment or buying new equipment.

Due to the complexity of such decisions, which can include the calculation of the cost of capital and the anticipated return on the investment using present value methods, it is recommended that the entrepreneur makes use of the assistance of an accountant.

Self Assessment Exercise 1:

Mention some examples of fixed expenses in business operations.

3.2 PRO FORMA INCOME STATEMENTS

Since sales constitute the major source of revenue in business operations particularly in manufacturing and merchandising businesses, and given the fact that other operational activities and expenses relate to sales volume, it is usually the first item that must be defined.

An example of a pro forma statement is chartered out in Figure 11.2. It shows all the relevant data relating to a period of six months of the initial year of operation for a new business. This example has been prepared for a manufacturing company.

The trend in demands portrays some fluctuations within the six months period used for the example. In order to prepare the pro forma income statement, the sales figures for the relevant months must be calculated on monthly basis as first step. The use of marketing research, industry sales, and some trial-and-error approach does and can provide the basis for these figures.

Furthermore, forecasting techniques can be of help for estimation of the monthly sales figures. Some examples of the forecasting techniques such as survey of buyers intentions, composite of sales force opinions or time series may be used to project sales by the entrepreneur.

The teething period of a new business does affect the sales of a product. Hence, marketing hiccups within the teething period will make it to take a while for new venture to build up sales. The operational expenses for achieving these increases can be disproportionately higher in some months, depending on the given situation in any particular period.

The figure below also portrays that the pro forma income statements also provide projections of all operating expenses for each of the months during the initial period of operations. Normally, each of the expenses is expected to be listed and carefully assessed to make sure that any increases in expenses are added in the appropriate month.

Due to operational workings, expenditures in selling operations such as traveling, commissions, entertainment, and bonuses among others should be expected to increase to some extent, as marketing territories are expanded and as new sales people or representatives are employed by the firm.

Moreso, selling expenses as percentage of sales may also be expected to be higher initially. This, given the fact that more sales visits or calls will have to be made to generate more turnover particularly when the firm is an unknown quantity.

Essentially, salaries and wages for the business should reflect the number of personnel employed relation to their role in the organization. In the course of operation, as new personnel are employed to support the increased business operations, the cost will need to be incorporated in the pro forma statement.

In the month of March, for example, a new employee is added to the staff payroll which raised the salaries and wages. Other increases in salaries and wages also reflect increase in the number of employees working for the company.

The entrepreneur should, in the course of business operations, consider the need to increase insurance cover, attend special exhibitions and trade fairs, or add space for warehousing. All of these should be incorporated or reflected in the pro forma statement.

From the example below, insurance for liability, medical, additional assets and so on is increased in the months of May and June. The relevant increase in insurance charges can be determined easily from an insurance company and reflect the status of the operations at the appropriate time.

Operating expenses such as utilities, rent, insurance, and interest can be more easily determined the entrepreneur knows the forecasted sales for the initial period under consideration. On the other hand, selling expense, advertising, salaries and wages, and taxes can be calculated individually on the basis of a percentage of the projected net sales.

In the process of calculating the projected operating expenses, it is strongly recommended that the entrepreneur be conservative for the initial planning purposes. Essentially therefore, a reasonable profit that is earned using the conservative estimates lends credibility to the potential success of the new venture.

Figure 11.2: A Pro Forma Income Statement (N'000) First Six Months

	Jan	Feb	Mar	Apr	May	June 90.0
Sales						
Less: cost of goods sold	58.0	61.0	60.0	64.0	72.0	76.0
	32.0	34.0	35.0	36.0	38.0	39.0
Operation expenses: Selling expenses	7.5	7.8	7.8	8.3	9.0	9.5
Advertising	3.0	7.0	3.0	3.5	4.0	4.5
Salaries and wages	8.0	8.0	8.3	8.3	9.5	10.0
Office supplies	1.9	1.0	1.0	1.2	1.4	1.5
Rent	2.0	2.0	2.0	2.0	3.0	3.0
Utilities	0.7	0.7	0.7	0.8	0.9	1.1
Insurance	0.3	0.3	0.3	0.3	0.6	0.6
Taxes	1.6	1.6	1.6	1.7	1.9	2.0
Interest	1.2	1.5	1.5	1.5	1.5	1.5
Depreciation	3.3	3.3	3.3	3.3	3.3	3.3

Miscellaneous				0.1	0.2	0.20.2	0.2	0
Total operation expenses	28.6	33.4	29.4	31.1	35.3	37.2		
Profit (loss) before taxes	3.4	0.6	5.6	4.9	2.7	1.8		
Taxes 1.7	0.3	2.8	2.45	1.35	0.9			
Net profit (loss)	1.7	0.3	2.8	2.45	1.35	0.9		

Self Assessment Exercise 2:

(a) What is pro forma income statement?

(b) Mention the various items of operations that are included in a pro forma income statement.

3.3 PRO FORMA CASH FLOW

Cash flow is obtainable from the difference between actual cash receipts and cash payment. Moreso, cash flows only when actual payment payments are received or made. Therefore, cash flow is different from profit from operations. Normally, profit is the result of the difference between total expenses and sales.

You will understand from discussion under the pro forma income statement that amount form sales may not be regarded as cash because a sale may be generated but payment may not be received until after some months.

Furthermore, it is not all the bills that are paid immediately. It is instructive to note that cash payments made in order to reduce the principal on a loan do not constitute a business expense. Nevertheless, such payments do constitute some reduction in cash available to the business.

In addition, depreciation on the capital assets of the firm is an expense, which reduces profits, but it is not a cash outlay. Understandably, one of the major problems that a new business venture faces is cash flow. On many occasions, some profitable firms do encounter operational problems such as financial distress because of lack of cash. Hence, the use of profit as a measure of operational success for a new venture may be misleading if there is a significant negative cash flow.

In pro forma cash flow, it is very essential for the entrepreneur to make monthly projection of cash flows. It is also necessary for the entrepreneur to make monthly projection for profits. The estimates incorporated in the cash flow projections are derived from the pro forma income statement. Essentially, some modifications are normally made to account for the expected timing of the change in cash flows.

For example, when disbursements exceed the receipts in any time period, the entrepreneur should either borrow funds or maintain cash reserve in a bank account to take care the higher disbursements.

In some months there may be large positive cash flows. Such cash flows in any time period should be invested in short-term sources or deposited in a bank. This will be utilized to cover future time periods when disbursements exceed receipts of cash. Experience has shown that the first few months of the operations of a new business will require external cash (debt) financing in order to cover the cash outlays.

In the course of the business operations, the business may succeed to the extent that cash receipt may accumulate, which may enable the entrepreneur to utilize such surplus to support negative cash periods. Figure 11.3 illustrates the preparation of a pro forma cash flow over a period of six months.

In some instances, there may be a negative cash flow based on receipts compared with disbursements in the period under consideration. Therefore, the possibility of incurring negative cash flows is very high for any new venture. Nevertheless, the amounts and length of time before cash flows from operations become positive will vary. It all depends on the nature of the business.

Experience has shown that the most difficult issue with projecting cash flows is determining the exact monthly receipts and disbursements in operations. Hence some assumptions are necessary. Such assumptions should be conservative in order for the business to accumulate enough funds to cover the negative cash months.

Figure 11.3: A Pro forma Cash Flow for Six Months (N’000)

	Jan	Feb	Mar	Apr	May	June
Receipts:						
Sales	86.0	93.0	95.0	98.0	106.0	113.0

Disbursements:

Cost of goods	55.4	61.4	60.2	63.2	70.4	75.2
Selling expense	6.75	7.65	7.8	8.05	8.55	9.25
Salaries	8.0	8.0	8.0	8.3	9.5	10.0
Advertising	3.0	7.0	3.0	3.5	4.0	4.5
Office supplies	0.85	0.95	1.0	1.1	1.3	1.45
Rent	2.0	2.0	2.0	2.0	3.0	3.0
Utilities	0.7	0.7	0.7	0.8	0.9	1.6
Insurance	0	0.5	0	0	0	0
Loan principal and interest	2.6	2.9	2.9	2.9	2.9	2.9
Total Disbursement:	81.5	92.4	86.9	92.15	102.05	109.0
Cash flow	4.5	0.6	8.1	5.85	3.95	4.0
Beginning balance	23.4	27.9	28.5	36.6	42.4	546.4
Ending balance	27.9	28.5	36.6	42.45	46.4	50.5

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In the process of business transaction, it is the total pecuniary amount form goods sold that is not normally paid for by the buyers in cash; thus the amount is paid piece meal by the debtors. For instance, the receipt can be 30 percent in cash during the first month, 40 percent received the following month, and the remaining 40 percent received during the third month.

In the same breadth, similar trends can hold sway for other disbursements. For example, the trend can be that it is expected that 80 percent of the cost of goods will be a cash outlay in the month incurred. The remaining 20 percent is paid in the next month. Additional cash outlays will be made for purchase of stock materials to maintain an inventory.

On the basis of conservative estimates, cash flows can be determined for each month. Such estimates of cash flows will also assist the entrepreneur in determining how much money he or she will need to borrow for operations. For the purpose of operations, some money can be borrowed from a bank and additional funds can come from the personal savings of the entrepreneur, to augment cash available.

On the other hand, cash reserves can emanate from tremendous amount of sales, and therefore, as sales build up and cash receipts can exceed cash disbursements. Such cash surplus can be utilized to repay any debt. Alternatively, the surplus can be invested in highly liquid assets as a safeguard in case of negative cash in other months, or it can be utilized to purchase any new capital equipment.

It is instructive to note that the pro forma cash flow, like the pro forma income statement, is based on mere estimates. Once the business begins operations it may be prudent to revise cash flow projections in order to ensure that their accuracy will protect the firm from any probable adversity.

Therefore, it is only prudent that the estimates or projections should incorporate some assumptions so that potential investors will be acquainted with how and from where the figures were generated.

For both the pro forma income statement and the pro forma cash flows it is occasionally helpful to provide several scenarios. Essentially, each of such scenarios is based on different levels of accomplishment of the business. These scenarios and projections are meant not only to serve the purpose of generating pro forma income and cash flow statements but, more significantly to make the entrepreneur understand the factors affecting the operations.

3.4 PRO FORMA BALANCE SHEET

It is very essential for the entrepreneur to also prepare a projected balance sheet to portray the likely condition of the business at the end of the first year. In the preparation of the balance sheet, the entrepreneur will have to utilize the projections or estimates as incorporated in both the pro forma income and cash flow statements.

The use of the estimates will help to justify some of the figures in the projections since the pro forma balance sheet is a product of both the pro forma income and pro form cash flow statements. The pro forma balance sheet is meant to reflect the position of the business at the end of the first year. Hence the pro forma balance sheet summarizes the assets, liabilities and net worth of the entrepreneur.

In the process of business operations, all the business transactions affect the balance sheet. Nevertheless, because of conventions and the need to monitor overall performance of the business, it is common to prepare balance sheets at periodic intervals such as quarterly, semi-annually and annually. Therefore, the balance sheet is prepared to reflect the picture of the business at a certain moment in time, and it is meant to cover a defined period of time.

Figure 11.4 depicts a balance sheet of a new business. From the figure, it can be discerned that the total asset equals the sum of the liabilities and owners equity.

Therefore, the two sides of a balance sheet must be equal and this must be borne in mind by the entrepreneur in case he or she is the one preparing it and being handled by an expert such as an accountant. The necessary categories of the balance sheet are discussed below:

1. Assets

The assets represent all the operational facilities, stock of goods, debtors' obligations to the business, and cash balances, among others, in the course of the operations of the business. The assets are all things of value that are owned by the business. The assets of a business are categorized into current or fixed assets.

i) Current Assets

The current assets include cash balances, stock of goods, and debtors' obligations to the business. It means that current assets incorporate cash and anything else that is expected to be converted into cash or consumed in the course of operation of the business during a period of one year or some months or even days.

These current assets are often dominated by receivables or money that is owned to the new venture from customers. Management of these receivables is important to the cash flow of the business since the longer it takes for customers to pay their bills the more stress is placed on the cash needs of the venture.

ii) Fixed Assets

Fixed assets are those assets that are tangible such as machines, equipment, motor vehicles, tables and chairs, and all other facilities being utilized in the course of business operations over a long period of time; beyond one year.

2. Liabilities

The liabilities constitute the claims of the owner (the entrepreneur) of the business and the financial obligations of the business towards outsiders such as bank, credit facility benefactors, and trade creditors. Some of these financial obligations or accounts may be due for payment within a year while other take go beyond one year.

i) Current Liabilities

These are the financial obligations or accounts that will be due for payment within a year; months or days. Examples of such current liabilities include bank overdrafts, short term credit facilities, payments in arrears and trade creditors.

i) Long-term Liabilities

These are financial obligations which have to be repaid over a long period of time such two years and more. These are the long-term debts such as loans from individuals, banks and other financial institutions.

iii) Owner Equity

The owner equity is the amount of funds which belong to the owner (the entrepreneur) of the business. In essence it can be regarded as representing the excess of all assets over all liabilities. Therefore, it represents the net worth of the business. The amount that is invested into the business by the entrepreneur is included in the owner equity or net worth section of the balance sheet.

In addition, any profit generated during the course of the business will also be included in the net worth as retained earnings. Thus, all amounts of revenue increase assets and owner equity and all transactions involving expenses decrease owner equity and either increase liabilities or decrease assets.

Figure 11.4:

A Pro Forma Balance Sheet at End of One Year (N'000)

Assets: Current Assets	N		N
Cash balance	50,400		
Debtors	40,000		
Stock	9,400		
Prepayment for utilities	200		
Total current assets Fixed Assets Equipment	100,000		100,000
	240,000		
Less: Depreciation		40,000	

Total fixed assets		200,000	200,000
Total assets			300,000
Liabilities & Equity: Creditors			
	23,700		
Loan payment	16,800		
Total current liabilities	40,500		40,500
Long-term Liabilities Loan			
			209,200
			249,700
Owner's equity	50,000		
Retained profit	350		
Total owner equity	50,300	50,300	
Total liabilities & owner equity		300,000	

Self Assessment Exercise 3:

Differentiate between pro forma cash flow and pro forma balance sheet.

3.5 PRO FORMA SOURCES AND USES OF FUNDS

The pro forma sources and applications of funds statement is normally prepared to reflect the possible disposition of earnings from operations and from other financing. Therefore, it is normally prepared for the purpose of showing how net income will be used to increase assets or to pay off debts.

It may be difficult for the entrepreneur to calculate how the net income for a year will be disposed of and the effect of the movement of cash through the business. Nevertheless, he or she will have to estimate such movement of funds in business operations.

The relevant questions that can be of great help are: Where will the cash come from? How will the cash be used? What happened to the various items of assets during the period? Figure 11.5 is prepared to portray the sources and applications of funds for a business in the course of its operations in a given period under consideration.

Much of the funds estimated for the preparation are assumed to be obtained from personal funds of the entrepreneur and loans from some benefactors. Since it has been assumed that at the end of the first year operations a certain level of profit will be earned, such profit too would be added to the sources of funds.

The depreciation charge is normally added back because it does not represent an outright expense in the course of business operations. Hence, in business operations typical sources of funds are from operations, new investments, long-term borrowing, and sale of assets.

The major uses or applications of funds are employed to increase operational assets, repay long – term loans, reduce owner or entrepreneur's equity, and pay other for other liabilities.

The sources and applications of funds statement normally emphasize the interrelationship of all the items of the working capital. Hence, the statement helps the entrepreneur and prospective investors to effectively appreciate the financial well-being of the business. It can also be used to understand the effectiveness the financial management policies of the business.

Figure 11.5:

A Pro Forma Sources and Applications Source of funds

	N	N	
Loan facilities		225,000	
Personal funds		50,000	
Net income			5,400
Add: depreciation		39,600	
Total funds provided		N320,000	

Applications of funds:		
Purchase of equipment	240,000	
Inventory	10,200	
Loan payment	16,800	
Total funds expended	267,000	267,000
Net increase in working capital		53,000
Total funds provided		N320,000

In business operations, it is often indispensable to delay the payments of some financial obligations in order to manage the cash flows effectively. Nevertheless, prompt settlement of such financial obligations to outsiders can be used to establish credit ratings and a good relationship by the firm with suppliers. Ideally, any business owner would want debts to be paid on time by debtors so that he or she can use such funds to pay his or her own debts to outsiders on time.

In the period of downturn in business resulting from economic phases such as depression and recession, many firms would hold back some payments in order to better manage cash flows. The problem inherent in delay of payments financial obligations to outsiders is that while the entrepreneur may think that slower payment of such obligations will generate better cash flow.

On the other hand, he or she may also discover that the debtors are also thinking of the same thing, with the result that no one gains any cash advantage. Nevertheless, this type of strategy in payment cannot be avoided in business operations.

3.6 BREAK-EVEN ANALYSIS

It is conventional that during the initial stages of operations of a new venture, it is helpful for the entrepreneur to determine when profits may be achieved. Such determination will provide, to some extent, further insight into the financial potential for the start-up business.

The entrepreneur will discover that the starting point is the use of the break-even analysis, which is a useful technique for determining how many units must be sold or how much sales volume must be achieved in order to achieve breakeven; a level of operations where the entrepreneur incurs no loss or makes any profit.

A business venture may start making, from the projections in the pro forma income statement, a profit in the earlier months of operations. Nevertheless, you will understand that this is not the break – even point. This is because the firm may have some obligations to meet for the remaining months of the year, regardless of the number of units sold.

Such obligations are in the areas of overhead costs of operations. These obligations known as fixed costs must be covered by sales volume in order for a company to break even. Hence, breakeven is that volume of sales at which the business neither makes a profit nor incurs a loss.

Essentially, therefore, the break – even sales point indicates to the entrepreneur the volume of sales required to cover total variable and fixed expenses. Hence, sales volume in excess of the break-even point will result in a profit provided that the selling price remains above the costs necessary to produce each unit (variable cost) of the output.

For the determination of the break –even quantity given the required unit price, variable cost per unit and the total fixed cost of operation, the formula is as stated below:

B/E(Q) = TFC

SP- VC per unit

SP – VC = the contribution margin TFC = total fixed cost

SP = selling price per unit VC =variable cost per unit

Once the selling price of the product is greater than the variable costs per unit of production, some contribution can be made to cover fixed costs. Ultimately, these contributions will be sufficient to pay all fixed costs, at which point the firm has reached breakeven

On one hand, the fixed costs are those costs that, regardless of the quantity of output remain constant. It means that any changes in present productive capacity do not the level of fixed cost. Hence the fixed costs are not affected by changes in volume of output.

On the other hand, the variable costs are those items of cost of operations that are affected in total by changes in volume of output or any changes in present productive capacity. The variable cost per unit refers to all those costs attributable to the production of one unit of output. This type of cost is constant within a defined level of production.

Figure 11.6: A Break-even Estimation by Graphical Method

N’000 650
600

550

500

450

400

350

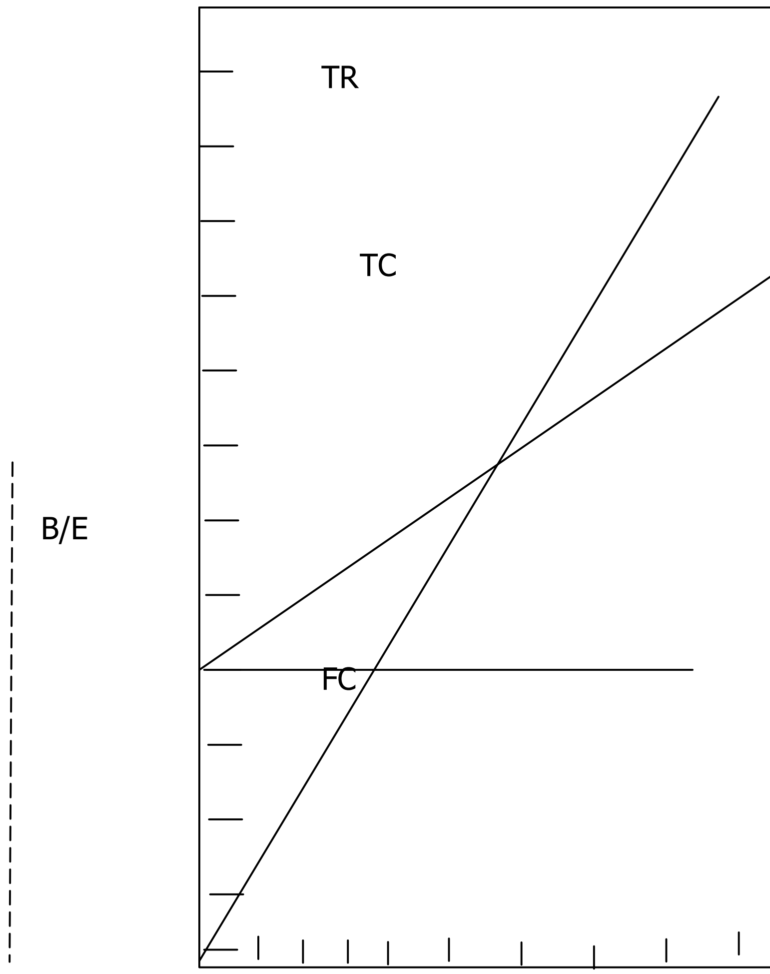
300

250

200

150

100



50
10 20 30 40 50 60 70 80 90
100

Production of Output in Units (000)

or new ventures the determination of the breakeven will require some judgment. This is because the major drawback in calculating the breakeven lies in determining whether a cost is fixed or variable. Nevertheless, it is some items of cost such as depreciation, salaries and wages, rent, and insurance are fixed.

Other items of cost such as materials, selling expenses (commission, bonus, etc) and direct labor are most likely to be variable costs. Hence, the variable cost per unit can usually be determined by allocating the direct labor, materials, and other expenses that are incurred with the production of a single unit.

Thus, assuming we want to determine the breakeven in quantity for a given firm with information such as fixed costs of N250,000, variable cost per unit is N5.50, and a selling price of N11.00, the breakeven will be as follows:

$$B/E = \frac{TFC}{SP - VC/unit}$$

$$= \frac{N250,000}{N11.00 - N5.50}$$

$$= \frac{250,000}{5.50}$$

$$= 45,454 \text{ units}$$

The breakeven quantity from the calculation above is 45,454 units. Hence any quantity beyond 45,454 units that is sold by the firm will result in a profit of N5.50 per unit. Sales below the quantity of 45,454 units will result in a loss of N5.50 per unit to the firm.

In the instances where a firm produces more than one product, breakeven should be calculated for each product. The apportionment of fixed costs would be allocated on the basis of each product or be determined by weighting the costs as a function of the sales projections.

For instance, it might be assumed that 40 percent of the sales are for a particular product; hence 40 percent of total fixed costs would be allocated to that product. If the entrepreneur presumes that a product requires more advertising, overhead, or other fixed costs, such trend should be included in the calculations.

A unique aspect of a breakeven analysis is that it can be graphically displayed, as shown in Figure 11.6. In addition, the entrepreneur can calculate various breakeven units by using different selling prices, different fixed costs, and variable costs to ascertain their impact on quantity of output and by extension, the level of subsequent profits.

There are a number of financial software packages that are available for the use of the entrepreneur that can be deployed to track financial data and generate many important financial statements. For the purpose of completing the pro forma statements, at least in the business planning stage, it is may be easiest to make use of a spreadsheet program.

The above reasoning is that since numbers may change often as the entrepreneur attempts to develop budgets for the pro forma statement.

The value of using a spreadsheet in the start-up phase for financial projections for a new business by the entrepreneur is simply being able to present different scenarios and thus being able to assess their impact on the price variations on pro forma income statement.

The analysis by using the computer spreadsheet software will provide a quick assessment of the likely financial projections given different scenarios. It is therefore, recommended that in the start-up period where the venture is very small and has limited resources, that the software selected be very simple and easy to use.

Fundamentally, the entrepreneur will need software to maintain the books of accounting records and to generate financial statements. Most of these software packages can allow for cheque writing, payroll, invoicing, inventory management, settlement of bills, credit management, and taxes, among others

There are many software packages which are available for personal computers and all provide all or most of the features relevant for the issues discussed above. It is necessary for the entrepreneur to consult a computer expert before deciding on a package. The entrepreneur may want to discuss the options with a consultant who has some knowledge of the entrepreneur's needs and the benefits of each of these software packages.

4.0 CONCLUSION

For a new business venture it is necessary to make some financial projections with which the entrepreneur can assess the financial implications of the new business before embarking on to operations. The financial evaluation calls for consideration of operational cost and likely cash flows from operations in order to convince himself or herself the business is a profitable venture.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to financial analysis.

- Operating and Capital Budget
- Pro Forma Income Statements
- Pro Forma Cash Flow
- Pro Forma Balance Sheet
- Pro Forma Sources and Uses of Funds
- Break-Even Analysis.

In the next study unit, we shall discuss the issue of financial planning.

6.0 TUTOR MARKED ASSIGNMENT

Prepare a simple projected manufacturing budget from these figures:

January	February	March Projected sales	
(units)	800	900	1,000

Inventory at the beginning of operations: 40, 20, 80 for the three months respectively. The inventories in units at the end of the three months respectively are: 100, 200, and 50.

What are the units of total production required for the three months from the calculation?

Solution to Self Assessment Exercises

SAE 1. Examples of fixed expenses in business operations are as follows:

- Rent
- Rates
- Utilities
- Salaries
- Interest
- Depreciation
- Insurance

SAE 2.

Pro forma income is normally prepared to calculate the project net profit obtainable from projected revenues in comparison with projected costs and expenses from operations.

The various items of operations that are included in a pro forma income statement are as follows:

- Sales volume
- Cost of goods
- Selling expenses
- Advertising
- Salaries and wage
- Office supplies
- Rent
- Utilities
- Insurance
- Taxes
- Interest Charges
- Depreciation
- Sundry expenses

SAE 3.

Pro forma cash flow is prepared to project cash flows (both cash inflows and outflows) of a business as calculated from projected cash accumulations (cash inflows) minus projected cash disbursements (cash outflows).

On the other hand, the pro forma balance sheet is normally prepared to summarize figures of the projected assets, liabilities, and net worth of the new venture.

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UNIT 12: FINANCING PLAN

CONTENT

1.0 INTRODUCTION

The previous study unit, as you will recall, is used for the discussion on financial analysis in terms of financial projections for a new venture. The projections on likely financial performance of a new venture do not translate into operations if they cannot be used to secure funding with which to operate by the venture. Generating funding for the venture can be very dicey in the face of unpredictable nature of a new venture.

The entrepreneur may not desire external funds if he or she can provide all the needed funds for initial operations. Nevertheless, new venture needs funds from

different sources so that the entrepreneur can take advantage of maximizing returns while paying fixed costs on external funds, called trading on equity. This study unit, therefore, is used to discuss some common sources of funding or capital that are available to an entrepreneur.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- Explain the implications of securing funds from varied sources
- Mention and discuss internal sources of funds
- Identify and explain external sources of funds

3.0 MAIN CONTENT

3.1 SECURING FINANCING FOR A NEW VENTURE

One of the most critical problems that can confront by an entrepreneur is securing financing for his or her venture. It is always a problem throughout the life of the enterprise, but it is particularly acute for a new venture. From the entrepreneur's point of view, the longer the venture can operate without external funding, the better because of obvious implications such as lower cost of the capital in operation.

In essence, the lower the cost of capital in terms of interest payment or equity loss in the venture, the better for the entrepreneur in terms of operational profitability. For a funds provider, a potential investment opportunity needs to have appropriate risk/return ratio. Therefore, a higher rate of interest will always be charged by investors on funds provided for a new venture which is characterized by greater risk of operations.

There are some viable sources of funding which are available to the entrepreneur for financing a new venture. Such sources are derived from some of the normal sources of funds which are normally utilized by business enterprises in operational activities.

Securing the funds from conventional sources by the entrepreneur for a new venture can be very unpredictable. New ventures are bound to go through murky waters, and therefore, they are bound to face tough time surviving in a dynamic environment of business competitive. This is the issue that defines the ease or otherwise with which the entrepreneur can access funds for a new venture.

Nevertheless, it is not always easy for a new venture to access defined sources of finance with which to operate. This is because the potential providers of funds for such a venture may be skeptical about the future of the venture particularly if the promoters or entrepreneurs are relatively unknown.

However, it is not difficult for funds to be accessed from different sources if the promoter or the entrepreneur has worked in reputable corporate bodies and credited with profound performance, innovative moves, strategic ideas in management of productive resources (funds, men and materials), and entrepreneurial skills. Generally, an investor will be interested in seeking to maximize return for a given level of risk or minimize risk for a given level of return.

The various sources of financing available to a venture are identify and discussed in subsequent subsections of this unit.

Self Assessment Exercise 1:

Give reasons why it may be difficult for a venture to secure finances

3.2 INTERNAL SOURCES OF SECURING FUNDS

The internal sources of financing a new venture provide veritable funding for the venture because they are readily available and accessible to the entrepreneur. These sources provide the initial or takeoff funding for the venture since the funds are partly from the entrepreneur and partly from the family members and friends, and from the venture itself in the course of its initial period of operations. Each source is discussed below.

Personal Contribution

The usual scenario is that the entrepreneur is expected to provide some contribution for the operations of a new venture, no matter how little the amount is. This amount of personal funds from the entrepreneur can be used as a basis for assessing the seriousness of the entrepreneur in establishing and running the business. This assessment will in turn influence the decision of external funds financiers to provide their funds for the venture.

The personal funds are considered least expensive in terms of cost and control, and above all they are considered absolutely necessary in attracting outside financing, particularly from banks, private investors, and venture capitalists. These outside providers of funds may conclude that the entrepreneur is not sufficiently committed to the venture if he or she does not have his or her invested in the business the necessary

The magnitude of personal contribution by the entrepreneur is indicative of the fact that he or she will not swindle external investors, will not abandon the business in the face of adverse situation, and above all, will commit all his or her efforts and time to ensure profitable operations and survival of the business. In essence, prospective external investors will be assured that the entrepreneur will not throw caution or business ethics to the wind in the course of running the business.

The level of commitment of the entrepreneur is also reflected in the magnitude of the total assets available to the venture as provided by him or her through personal efforts and funding. This also assures the external investors that the entrepreneur truly believes in the fate of the venture, and will work assiduously to ensure that the venture succeeds.

You should always bear it at the back of your mind that it is not just the amount of personal contribution that matters but the fact that all the monies available are committed in form of capital assets acquired for the use of the business. This is what the outside investors will consider and be encouraged, by the entrepreneur's commitment to the business, to invest in the venture.

3.2.1 Business Funds

Some financing is also associated with internal source such as funds from sale of assets already introduced by the entrepreneur, reduction in working capital, and reduction in the amount earmarked for the preliminary expenses.

In a new venture, as the business commences operations, the profits being generated can be ploughed back into the venture since outside investors and creditors do give the entrepreneur the opportunity to wade through the teething period without making payback of debts. Therefore, during moratorium period both debt instruments holders and outside equity investors would allow the venture to operate unhindered in terms of not expecting any payments to them.

In the course of operations of the venture the entrepreneur can obtain the needed funds by selling little-used assets. Such assets if not all the assets can be sold and leased back by the entrepreneur so as to generate additional funds. By using the assets on leasehold basis, the venture will be able to conserve cash that is particularly critical during the start-up phase of the business operations.

Another source of internal funds is the short-term funds obtainable from the reduction in short-term assets such as inventory, cash, and other working-capital items. For instance, the entrepreneur can generate cash through extended payment terms from suppliers. The entrepreneur can establish longer payment period such as sixty (60) days or ninety (90) days. Once this is established as a policy, the suppliers will have no choice other than to adhere to it provided that the entrepreneur does not renege on it.

There is the other source of generating funds internally, which is through bills collection in connection with the accounts receivable. The period of collection can be shortened by the entrepreneur in order to gain advantage by selling the debts to discount companies for immediate cash but at discounted amount lower than their face values. The period of receivable can also be shortened by the entrepreneur by offering generous cash discounts to the debtors for prompt payment. The entrepreneur's bankers can also be great help in this arrangement by negotiating with them for credit facilities on the strength of trade debts.

3.2.2 Funds from Family and Friends

There is the window of opportunity in raising funds from family members and friends by the entrepreneur. This is a veritable source of financing for the venture because of the entrepreneur's personal relationship with family members and friends. Family members and friends are mostly likely to invest in the venture due to their relationships and being readily accessible to the entrepreneur.

The use of funds from family members and friends can be used to rekindle the confidence of impersonal investors because such knowledge by them will help overcome their feel of uncertainty about the venture and the promoter's commitment to the survival and profitable operations of the business. The little contribution in form of advances and equity from family members and friends is relatively easy to obtain reflecting in part the commitment of such parties towards the success of the business.

There are some pros and cons in securing funds from family members and friends to finance a venture. Such issues should be evaluated by the entrepreneur before making of them. Equity funds from family members and friends could reduce degree of control for the entrepreneur. This form of contribution to the capital funds of the business confers ownership on family members and friends, and therefore, the same rights and privileges with the entrepreneur in the business.

In order to avoid potential future problems in involvement of family members and friends in partnership ownership of the business, the entrepreneur must weigh the pros against the cons coupled with the nature of the risks of their investment before seeking and accepting their funds into the venture. In order to minimize any future problems, any loans or investments from family members and friends should be treated in the same businesslike manner that would occur if the financing comes from an impersonal investor.

Self Assessment Exercise 2:

What are the advantages of using internal sources of financing a new venture?

3.3 EXTERNAL SOURCES OF SECURING FUNDS

Funding of a new venture can also comes from sources other than the entrepreneur, family members and friends, and the operations of the business. Fundamentally, there are three basic bases for evaluating the use of external sources of financing a new business venture. These include: the length of time the funds will be available; the cost implications of the sources; and the degree of loss of control by the entrepreneur in the process of them. Each of these factors needs to be considered in selecting the ideal source of external financing.

3.3.1 Equity Financing

Equity financing does not require collateral security from the entrepreneur. Equity contribution coffers on the investor some form of part ownership position in the venture. The investor who contributes the equity funds shares in the profit of the venture as well as any other benefits accruing from the operations pro rata basis; using quantum of shareholding.

Some basic factors favouring the use of equity financing include absence of cost, no obligations attached and there are no risks inherent in its use to the venture. The entrepreneur may decide to sue many sources of financing by employing a combination of personal funds, debt and equity financing.

Almost all ventures involve the use of some equity funds, particularly the corporate entities as they are all business ventures which are jointly owned by numerous shareholders in various economies all over the world. Since such shareholders are always many it is only a few people that are employed to work with the entrepreneur.

Larger business ventures may require multiple owners owing to various sources of funding that are required for use in running such ventures. The investors may include private investors and venture capitalist. The venture capitalist is discussed below. The equity funding provides the basis for debt funding since loan capital will not be provided in the absence of equity funding.

3.3.2 Venture Capital

This is a capital provided by non-bank financial institution or a wealthy individual investor or corporation in form of equity and quasi equity to a new venture that is at its start-up stage or in its early stage of development. Venture capital finance supplements or takes the place of credit facilities that the conventional banks are unwilling to give.

The provider of the venture capital funds may initially provide the financing facility as a loan but specifically with the intention of converting the debt into equity at a future period in the life of the enterprise. The return from such investment to venture capitalist is normally reasonable to compensate for the high risk involved in the operations of a new venture.

3.3.3 Debt Financing

Debt financing is a financing method involving an interest-bearing instrument. It is usually a loan, the repayment of which is indirectly related to the sales revenue and profit of the venture. Typically, debt financing also called asset-based financing requires that collateral security be pledged or provided by the entrepreneur with which to secure the loan by the lender.

Examples of collateral security include assets such as car, house, machine, or land, whose title of ownership is passed to the provider of loan funds at the instance of providing the funds. The collateral security serves as safety valve for the repayment of the facility. This is because in the event of default, the lender has the legal right to sell the asset pledged for recovering the funds which might have been committed on the loan.

Debt financing requires the entrepreneur to pay back the amount of funds borrowed plus a fee expressed in terms of agreed or negotiated interest rate. If the financing is short-term, which is repayable within one year, the money is usually used to finance or cover working capital to finance the inventory, accounts receivable, or the operation of the business. The funds are typically repaid from the resulting sales and profit during the year.

A long-term debt which is repayable beyond one year, is frequently utilized to purchase some operational assets such as a piece of machinery, land, building, vehicle or any other fixed asset. For a new venture, the asset so acquired with the loan is usually pledged as the collateral security.

In the event that the entrepreneur is introducing fixed assets into the venture, part of the value of such assets (from fifty to eighty percent of the total value) is usually being used as collateral for the long term loan. In a situation when interest rates are low, debt as opposed to equity financing allows the entrepreneur to retain a larger ownership portion and have a greater return on the equity.

The entrepreneur needs to be conscious that the amount of debt being taken to run the venture is not so large that regular interest payments becomes difficult if not impossible to meet, and growth and development of the venture inhibited. Therefore, the use of debt to run a new venture is very risky considering the fixed charge in form of interest payment and the repayment of the principal amount of the loan on regular basis.

3.3.4 EQUIPMENT LEASING

A new venture may not be buoyant financially to purchase all operational assts. Such fixed assets can be acquired through leasing, presupposes that the entrepreneur takes possession of them through leasing arrangement. The arrangement calls for release of the equipment or machinery by either the manufacturer or other party to the entrepreneur without part payment but on rental payments on periodic basis in the process of using the asset.

Essentially, the high cost of equipment which makes it difficult and sometimes possible for outright purchase of equipment makes leasing a viable option for new venture. Therefore, leasing is a significant tool for financing acquisition of operational (or fixed) assets without cash payment by the entrepreneur. Both the entrepreneur or user (the lessee) and the manufacturer or owners of the equipment (called the lessor) stand to benefit immensely from leasing arrangement.

Leasing becomes a good alternative means of financing the operations of a new venture in the face of the difficulty involved in meeting the requirement of providing collateral security for loan facilities from banks or other financial institution.

Furthermore, the possession and utilization of leased equipment without cash payment is very advantageous for a new venture since the promoter (or entrepreneur) may not have enough funds with which to finance purchase of fixed assets.

A leased contract provides a flexible payment plan from the onset of the contract, reducing cash-flow pressure on working capital. The working capital is very much needed for the operation or production. Leasing of items of equipment or machinery provides technological hedge for entrepreneurs thus making it possible to avoid ownership risk.

Self Assessment Exercise 3:

Mention the advantages of using equipment leasing in financing a new venture.

4.0 CONCLUSION

Securing funding for venture is not an easy task considering the unpredictable nature of a new venture. You will appreciate from the foregoing discussion that a new venture needs funds from different sources so that the promoter can take advantage of maximizing returns while paying fixed costs on external funds. The sources of financing are both internal and external to the venture. The entrepreneur, as you have understood, has control over the internal sources of funds as compared to the external sources; considering the fact those funds from the former can readily be available. The entrepreneur has to fulfill some conditions before he or she can access the funds from external sources.

5.0 SUMMARY

In this study unit, we have discussed the following topics as they relate to financing plan for a new venture.

- Securing Financing for a New Venture
- Personal Contribution
- Business Funds
- Funds from Family and Friends
- Equity Financing
- Venture Capital
- Debt Financing
- Equipment Leasing

In the next study unit, we shall discuss the issue of preparing business proposals.

6.0 TUTOR MARKED ASSIGNMENT

Mention and discuss the various sources available for financing a new business venture.

Solution to Self Assessment Exercises

SAE 1: The reasons why it may be difficult for a venture to secure finances are as follows.

i) Unpredictable nature of operations and performance of a new venture.

ii) Lack of investors' confidence in a new venture.

iii) Investors are interested in maximum return which a new venture may not provide.

iv) The promoter may not be credit worthy personally.

v) The entrepreneur may not be a person of any business substance.

vi) The entrepreneur or promoter may not be known to have profound business background.

vii) The entrepreneur may not be known to have entrepreneur skills.

SAE 2: The advantages of using internal sources of financing a new venture are as follows:

i) Internal funds are easily accessible.

ii) Does not involve much cost.

iii) Does not involve any form of risk.

iv) Constitutes the bedrock of financing of a venture.

v) Does not require fulfillment any conditionalities.

SAE 3: The advantages of using equipment leasing in financing a new venture are as follows:

i) No cash payment.

ii) No commitment of scarce funds before accessing equipment.

iii) The equipment involved can become the property of the venture after leasing period.

iv) Avails the entrepreneur accessibility to defined technology without commitment of funds.

v) Opportunity for exchanging leased equipment for a new one in the event of obsolescence.

vi) A leased contract provides a flexible payment plan from the onset of the contract, reducing cash-flow pressure on working capital.

vii) Leasing is an alternative means of financing in the face of the difficulty in providing collateral security for loan facilities.

viii) Paying high cost for equipment can be avoided by the entrepreneur.

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UNIT 13: PREPARING BUSINESS PROPOSALS

CONTENT

1.0 INTRODUCTION

Business undertaking cannot become operational without operational plans. These plans are normally designed to serve as strategic guides to the operators. The operation of a new business is no exception because running such a business is like muddling through murky waters. Therefore, in order for the entrepreneur to prepare for effective management of the new business, he or she has to formulate plans for the functional areas of operations. Hence the discussion in this study unit is focused on preparation of business proposals.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- Explain the meaning of business proposal
- Discuss the scope and value of the business proposal
- Discuss the evaluation of the business proposal
- Outline and write the business proposal

3.0 MAIN CONTENT

3.1 MEANING OF A BUSINESS PROPOSAL

The business proposal or plan is a written document prepared by the entrepreneur that describes all the relevant external and internal elements involved in starting a new venture. It is often an integration of functional plans such as marketing, finance, manufacturing, and human resources. It also addresses both short-term and long – term decision making for the first three years of operation.

Fundamentally, the business plan or the business game plan or road map is used to answer basic questions such as: where am I now? Where am I going? How will I get there? These questions are vital for an entrepreneur so as to provide a good stead for the business. The answers to these basic questions provide the needed road map for the operations of the business.

The business plan should be prepared by the entrepreneur. Nevertheless, the entrepreneur may consult with many other sources in its preparation. Such sources include the lawyer, accountants, marketing consultants, and engineers who are useful in the preparation of the plan. The Small and Medium Enterprises Development Agency of Nigeria should be useful for consultation in the preparation of the business plan. The Agency is charged with responsibility of encouraging the development of the small and medium enterprises in the country.

It may be necessary for the entrepreneur to consult with any of the above sources in order to ascertain their availability, scope of expertise, and fees. For example, the entrepreneur may decide to employ someone who could not only assist in the

preparation of the business plan but also become an important part of the management team to operate the business. In order to help determine whether to employ a consultant or to make use of other resources, the entrepreneur can make an objective assessment of his or her own skills and capability.

3.2 SCOPE AND VALUE OF THE BUSINESS PROPOSAL

The business plan may be read by employees, investors, bankers, venture capitalists, suppliers, customers, advisers, and consultants. Who is expected to read the plan can often affect its actual content and focus. Since each of these groups reads the plan for different purpose, the entrepreneur must be prepared to address all their issues and concerns. In some way, the business plan must try to satisfy the needs of everyone; whereas in the actual marketplace the entrepreneur’s product will be trying to meet the needs of selected groups of customers.

Nevertheless, there are probably three perspectives that should be considered when preparing the plan. First, the perspective of the entrepreneur who understands better than anyone the creativity and technology involved in the new venture. The entrepreneur must be able to clearly articulate what the venture is all about. Second the marketing perspective. Too often, and entrepreneur will only consider the product or technology and not consider whether someone would buy it. Entrepreneurs must try to consider their business through the eyes of their customer.

The customer orientation is important in the marketing plan. The third perspective is that of the investor. Sound financial projections are required; if the entrepreneur does not have the skills to prepare this information, then outside sources can be of assistance. The depth and detail in the business plan depend on the size and scope of the proposed new venture. An entrepreneur planning to market a new portable computer will need a quite comprehensive business plan, largely because of the nature of the product and market.

On the other hand, an entrepreneur who plans to open a retail video store will not need the comprehensive coverage required by a new venture in technology equipment. It all depends on whether the new venture is a service, involves manufacturing, or is a consumer good or industrial product. The size of the market, competition, and potential growth may also affect the scope of the business plan.

The business plan is valuable to the entrepreneur, potential investors, or even for the review of new personnel, who are trying to familiarize themselves with the venture, its goals and objectives. The business plan is important to these people because:

- It helps determine the viability of the venture in a designated market.
- It provides guidance to the entrepreneur in organizing his or her planning activities.

- It serves as an important tool in helping to obtain financing

Potential investors are very particular about what should be included in the business plan. Regardless of the fact some of the information is based on assumptions, the thinking process required to complete the plan is a valuable experience for the entrepreneurs. In addition, the thinking process takes the entrepreneur into the future, leading him or her to consider important issues that could impede the road to success. The process also provides a self-assessment by the entrepreneur. Usually, he or she feels that the new venture is assured of success.

Fundamentally, the planning process forces the entrepreneur to bring objectivity to the idea and reflect on some basic questions, which altogether serve as self- evaluation. Such questions that the entrepreneur is to bring into consideration in the formulation of business plan are as presented below:

- Does the idea make sense?
- Will it work?
- Who is my customer?
- Does it satisfy Customer needs?
- What kind of protection can I get against imitation by competitors?
- Can I manage such a business?
- Whom will I compete with?

This self-evaluation is similar to role-playing, requiring the entrepreneur to think through various scenarios and consider obstacles that might prevent the venture from succeeding. The process allows the entrepreneur to plan ways to avoid such obstacles. It may even be possible that, after preparing the business plan, the entrepreneur will realize the obstacles cannot be avoided or overcome. Hence, the venture may be terminated while still on paper. Nevertheless, this certainly is not the most desirable conclusion, but it would be much better to terminate the business endeavor before investing further time and money.

Self Assessment Exercise 1:

What are the benefits of a business plan?

3.3 PROSPECTIVE EVALUATORS OF BUSINESS PROPOSAL

There are some literature materials or computer software packages that are available for the use of the entrepreneur in preparing a business plan. Nevertheless, such sources should be used only to assist in its preparation. This is because ultimately the business plan should be designed to address the needs of all the potential users or evaluators.

You will appreciate the fact that the needs the potential users or evaluators may vary considerably and thus could result in rejection of the entrepreneur's request of not addressed accordingly in the business plan; especially if relevant information are incorporated in the plan.

It is believable that the entrepreneur will prepare a preliminary business plan from his or her own personal viewpoint without consideration of the constituencies that will ultimately read and evaluate the plan's feasibility. Nevertheless, as the entrepreneur becomes aware of who will use the plan, appropriate changes will be necessary.

1. The Suppliers

One constituency or user may be suppliers, who may want to see a business plan before signing a contract to either produce components or finished products or even supply large quantities of materials on consignment to the entrepreneur. The suppliers will be interested in the financial projections particularly the income statement so as to be assured of regular payments for their supplies.

2. The Customers

Customers may also want to review the plan before buying a product that may require significant long-term commitment, such as a high–technology telecommunication product. In this consideration, the business plan should be designed to incorporate the needs of this important constituency who may pay more attention to the experience of the entrepreneur in providing the products that meet their requirements.

3. The Lenders

Another constituency that may evaluate the plan is the potential providers of capital funds. The interest of lenders or investors will likely vary in terms of their needs and requirements in the business plan. For instance, lenders are primarily interested in the ability of the new venture to pay back the funds including interest within a designed period of time.

Characteristically, lenders focus on their attention on some basic considerations of credit lending; character, condition, cash flow, collateral, and capital, the equity contribution of the entrepreneur. Basically, what this implies is that lenders want the business plan to reflect the entrepreneur's credit worthiness, the ability of the entrepreneur to meet debt and interest payments (cash flow), condition of the economy, the collateral or tangible assets being secured for the loan, and the amount or personal equity that the entrepreneur has invested.

4. The Banks

Banks would be interested in facts and figures in terms of objective analysis of the business opportunity as espoused by the financial projections prepared by the entrepreneur. The banks would also be interested in all the potential risks inherent in the new venture that could be apparent from the pro form income statement.

The banks would also be interested in considerations of criteria of credit lending; character, condition, cash flow, collateral, and capital, the equity contribution of the entrepreneur. These are evaluated by the banks in order to assess the possibility of recouping their funds in the event of granting facilities to the new venture. In essence, such criteria are considered before the banks take decisions on whether or not to grant the venture some credit facilities.

5. The Investors

Investors such as venture capitalists always have different needs since they are providing large sums of capital for ownership (equity) and the expected recouping of their investment within some few years of the venture's operations. Investors often spend much time conducting background checks on the entrepreneur and on similar businesses.

Such checks by the venture capitalist are essential not only from a financial perspective but also because the venture capitalist will play an important role in the actual management of the business. Hence, the venture capitalists would want to make sure that the entrepreneur is compliant and willing to accept this involvement.

The prospective investors will also demand high rates of return and will therefore, focus on the market and financial projections during this critical period of the initial years of the business. In preparing the business plan, therefore, it is important for entrepreneurs to consider the need of these external sources and not merely providing information for their own perspective.

The above consideration on the need to incorporate the interest of the prospective users and evaluators in the business plan is of utmost significance. Such consideration will prevent the plan from being an internalized document that emphasizes only the technical advantage of a product or market advantage of a service.

Self Assessment Exercise 2:

Discuss the interest of prospective evaluators of a business plan.

3.4 WRITING THE BUSINESS PROPOSAL

The business plan could take much considerable period of time to prepare, depending on the experience and knowledge of the entrepreneur as well as the purpose it is intended to serve. A business plan should be comprehensive enough to give any potential investor a complete picture and understanding of the new venture and will help the entrepreneur classify his or her thinking about the business. Many entrepreneurs incorrectly estimate the length of time that an effective plan will take to prepare. Once the process has began, however the entrepreneur will realize that it is invaluable in sorting out the business functions of a new venture.

The outline of a business plan involves the details as identified and discussed below.

3.4.1 Introductory Page

This is the title or over page that provides a brief summary of the business plan's contents. The introductory page should contain he following:

- The name and address of the company.
- The name of the entrepreneur(s) and a telephone number.
- A paragraph describing the company and the nature of the business.
- The amount of financing needed. The entrepreneur may offer a package, that is, stock, debt, and so on. However, many users or suppliers of capital funds may prefer to structure this package in their own way.
- A statement of the confidentiality of the report. This is for security purpose and is important for the entrepreneur.

This title page sets out the basic concept that the entrepreneur is attempting to develop. Investors consider it important because they can determine the amount of investment needed without having to read through the entire plan.

3.4.2 Executive Summary

This section of the business plan is prepared after the whole plan is written. The executive summary should be capable of stimulating the interest of the potential investor, and it is about three to four pages in length. The investor uses the summary to determine if the business plan is worth reading in its entirety. Thus, it would highlight in a concise and convincing manner the key points in the business plan, that is, the nature of the venture, financing needed, market potential, and support as to why it will succeed.

3.4.3 Outline of a Business Plan

The outline of a business plan incorporates relevant sections of the plan which are used to detail out the vital information on the new venture the entrepreneur intends to establish and run on profitable operations. Such sections of a business plan are set out below.

i) Introductory Page

- Name and address of business
- Name(s) and address(es) of principal promoters
- Nature of business
- Statement of financing needed
- Statement of confidentiality of report

ii) Executive Summary

Contains information of three to four pages summarizing the complete business plan

iii) Industry Analysis

- Future outlook and trends
- Analysis of competitors
- Market segmentation
- Industry forecasts

iv) Description of Venture

- Products (s)
- Service (s)
- Size of business
- Office equipment and personnel
- Background of entrepreneurs

v) Production Plan

- Manufacturing process (amount subcontracted)
- Physical plant
- Machinery and equipment
- Names of suppliers of raw materials

vi) Marketing Plan

- Pricing
- Distribution
- Promotion
- Product Forecast
- Controls

vii) Organization Plan

- Form of ownership
- Identification of partners or principal shareholders
- Authority of principals
- Management background
- Roles and responsibilities of members of organization

viii) Assessment of Risk

- Evaluate weakness of business
- New technologies
- Contingency plans

ix) Financial Plan

- Pro forma income statement
- Cash flow projections
- Pro forms balance sheet
- Break-even analysis
- Sources and application materials)

x) Appendix

Contains backup material such as:

- Letters
- Market research data
- Leases or contracts

- Price lists from suppliers

In addition, the competitive analysis is also an important part of this section. Each major competitor in the industry should be identified, with their appropriate strengths and weakness described, particularly as to how they might affect the new venture's potential success in the market.

It is advisable that the potential market should be segmented and the target market for the entrepreneur identified. Most new ventures are likely to compete effectively in only one or a few of the market segments. This strategy may be a function of the competition because the new venture may be more vulnerable in one or a few segments of the total market.

3.4.4 Industry Analysis

The essence of industry analysis is to situate the new venture in a proper context in relation to a new venture's likely position in the industry. The potential investors, not only the entrepreneur, while assessing the venture on a number of criteria, need to do an industry analysis in order to know which industry the entrepreneur will be competing in.

The industry analysis involves evaluation of the industry outlook, taking into consideration the future trends as well as the historical achievements of the industry.

The entrepreneur should also provide insight on the venture's potential market share in relation to existing void he wants to fill in the industry.

The critical issues involved in industry analysis are as follows:

1. What are total industry sales over the past five years?
2. What is anticipated growth in this industry?
3. How many new firms have entered this industry in the past three years?
4. What new products have been recently introduced in this industry?
5. Who are the nearest competitors?
6. How will the business operation be better than this?
7. Is each of the major competitors' sales growing, declining, or steady?
8. What are the strengths and weakness of each of the competitors?
9. What is the profile of venture's customers?
10. How does the customer profile differ from that of the competitor?

3.4.5 Creating and Starting the Venture

This simple assessment of the location, market, and so on can save the entrepreneur from a potential disaster. Maps that locate customers, competitors, and even alternative locations for a building or site can be helpful in this evaluation.

Some of the important questions that might be asked by an entrepreneur are as follows:

- How much space is needed?
- Should I buy or lease the building?
- What is the cost per square foot?
- Is the site zoned for commercial use?
- What town restrictions exist for signs, parking and so forth?
- Is renovation of the building necessary?
- Is the facility accessible to traffic?
- Is there adequate parking?
- Will the existing facility have room for expansion?
- What is the economic, demographic profile of the area?
- Is there an adequate labour pool available?
- What are local taxes?
- Are electricity and plumbing adequate?

In the event that the building or site decision involves legal issues such as a lease, or requires town planning variations, the entrepreneur should enlist the services of a lawyer. Problems relating to regulations and leases can be avoided easily, but under no circumstances should the entrepreneur try to negotiate with the town or landlord without good legal advice.

3.4.6 Appendix

The appendix of the business plan generally contains any backup material that is not necessary in the main body of the document. Reference to any of the documents in the appendix should be made in the business plan itself.

Documents such as letters from customers, distributors, or subcontractors are examples of information that should be included in the appendix. Any documentation relating to information, that is, secondary data or primary research data used to support plan decision should also be included in the appendix. Lastly, price lists from suppliers and that being charged by the competitors may be added.

Self Assessment Exercise 3:

Mention the critical sections of a business plan. What are their necessary details?

4.0 CONCLUSION

Basically, the business plan or the business game plan serves as the road map for the operations of a venture. The plan is normally prepared to serve as strategic guide to the operators. The business proposal describes all the relevant external and internal elements involved in starting and running a new venture. It is often an integration of functional plans such as marketing, finance, manufacturing, and human resources, among others. The document is vital towards ensuring effective management of the venture. It is normally prepared to incorporate relevant information so as to attract patronage from prospective investors, suppliers, customers, and lenders of funds. In writing the plan the entrepreneur has take cognizance of relevant outlines and sections which are essential in enriching the document.

5.0 SUMMARY

In this study unit, we have discussed the following topics they relate to preparation of business plan or business proposals.

- Meaning of a Business Proposal
- Scope and Value of the Business Proposal
- Prospective Evaluators of Business Proposal
- Writing the Business Proposal
- Outline of a Business Plan
- Industry Analysis

In the next study unit, we shall discuss the issue of writing a loan proposal.

6.0 TUTOR MARKED ASSIGNMENT

Identify the critical sections of a business proposal showing their necessary details.

Solution to Self Assessment Exercises:

SAE 1: The benefits of a business plan are as follows:

i) It helps determine the viability of the venture in a designated market.

ii) It provides guidance to the entrepreneur in organizing his or her planning activities.

iii) It serves as an important tool in helping to obtain financing

iv) It makes the entrepreneur to project into the future, by considering important issues that could impede the road to success.

v) The plan also provides a self-assessment device for the entrepreneur; feeling that the new venture is assured of success.

vi) The planning process forces the entrepreneur to bring objectivity to the idea and reflect on some basic questions, which altogether serve as self-evaluation.

vii) The process allows the entrepreneur to plan ways to avoid future obstacles against the business.

SAE 2: The prospective evaluators of a business plan and their interest are discussed below.

i) The Suppliers

One constituency or user of a business plan may be suppliers, who may want to see a business plan before signing a contract to either produce components or finished products or even supply large quantities of materials on consignment to the entrepreneur. The suppliers will be interested in the financial projections particularly the income statement so as to be assured of regular payments for their supplies.

ii) The Customers

Customers may also want to review the plan before buying a product that may require significant long-term commitment, such as a high–technology telecommunication product. In this consideration, the business plan should be designed to incorporate the needs of this important constituency who may pay more attention to the experience of the entrepreneur in providing the products that meet their requirements.

iii) The Lenders

Another constituency that may evaluate the plan is the potential providers of capital funds. The interest of lenders or investors will likely vary in terms of their needs and requirements in the business plan. For instance, lenders are primarily interested in the ability of the new venture to pay back the funds including interest within a designed period of time.

iv) The Banks

Banks would be interested in facts and figures in terms of objective analysis of the business opportunity as espoused by the financial projections prepared by the entrepreneur.

The banks would also be interested in all the potential risks inherent in the new venture that could be apparent from the pro form income statement.

v) The Investors

Investors such as venture capitalists always have different needs since they are providing large sums of capital for ownership (equity) and the expected recouping of their investment within some few years of the venture's operations. Investors often spend much time conducting background checks on the entrepreneur and on similar businesses.

SAE 3: The critical sections of a business plan and their necessary details are as follows.

i) Introductory Page

- Name and address of business
- Name(s) and address(es) of principal promoters
- Nature of business
- Statement of financing needed
- Statement of confidentiality of report

ii) Executive Summary

Contains information of three to four pages summarizing the complete business plan

iii) Industry Analysis

- Future outlook and trends
- Analysis of competitors
- Market segmentation
- Industry forecasts

iv) Description of Venture

- Products (s)
- Service (s)
- Size of business
- Office equipment and personnel
- Background of entrepreneurs

v) Production Plan

- Manufacturing process (amount subcontracted)

- Physical plant
- Machinery and equipment
- Names of suppliers of raw materials

vi) Marketing Plan

- Pricing
- Distribution
- Promotion
- Product Forecast
- Controls

vii) Organization Plan

- Form of ownership
- Identification of partners or principal shareholders
- Authority of principals
- Management background
- Roles and responsibilities of members of organization

viii) Assessment of Risk

- Evaluate weakness of business
- New technologies
- Contingency plans

ix) Financial Plan

- Pro forma income statement
- Cash flow projections
- Pro forms balance sheet
- Break-even analysis
- Sources and application materials)

x) Appendix

Contains backup material such as:

- Letters
- Market research data
- Leases or contracts
- Price lists from suppliers

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UNIT 14 CASH FLOW ANALYSIS

CONTENTS

1.0 INTRODUCTION

A cash flow statement lists cash inflows and cash outflows while the income statement lists income and expenses. A cash flow statement shows liquidity while an income statement shows profitability. ... The purchase of livestock feed (cash method of accounting) is both an expense and a cash outflow item.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain cash flow analysis
- describe the preparation of a cash flow statement.

3.0 MAIN CONTENT

3.1 Cash Flow Analysis

Before we discuss Cash Flow Analysis, we must first define what a cash flow is. Perhaps let us start with the cash flow statement.

A cash flow statement is a statement that shows the receipt of cash (inflows) and the disbursement of cash (outflows). For an existing business, the cash flow statement can be prepared from the accounting records.

However, if a business is non-existent and about to start, what we have is usually called the Projected Cash Flow Statement. It is therefore important for us to understand the meaning of a projected cash flow statement.

A projected cash flow statement is a statement which shows the forecasts of cash receipts (inflows) and the disbursement of cash (outflows) of a firm or project.

It is important to note that the projected cash flow statement is not an income statement. It only captures the movement of cash in and out of a project.

The projected cash flow statement assists to evaluate the future performance of a firm or project. It enables the project evaluator to answer the following questions.

1. What are the products and services of the firm?
2. What are the revenues and cash expenses of the firm or project?
3. Will the projected cash flow be able to service the project's debts (loan, overdraft and interest)?
4. Will the project need financing and when?
5. How should the loan or overdraft be structured?

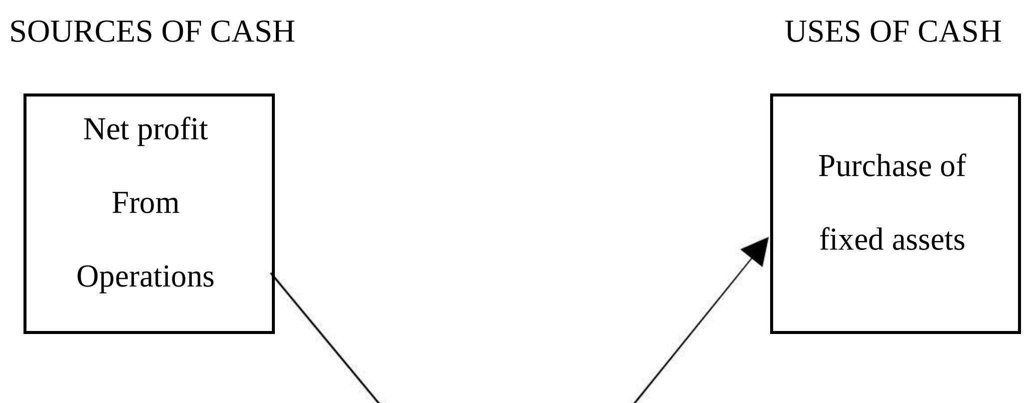
All answers to the above questions should be provided by the projected cash flow statement.

3.1.1 Users of the Projected Cash Flow Statement

We have defined the projected cash flow statement at least in the sense that we now know what it is all about. The next thing for us to do is to discuss who the users of the projected cash flow statement are:

- **The Project Promoter or Sponsor**

The project promoter is the initiator of a project. He/she will be interested in knowing well in advance what the cash flows of the project will be.



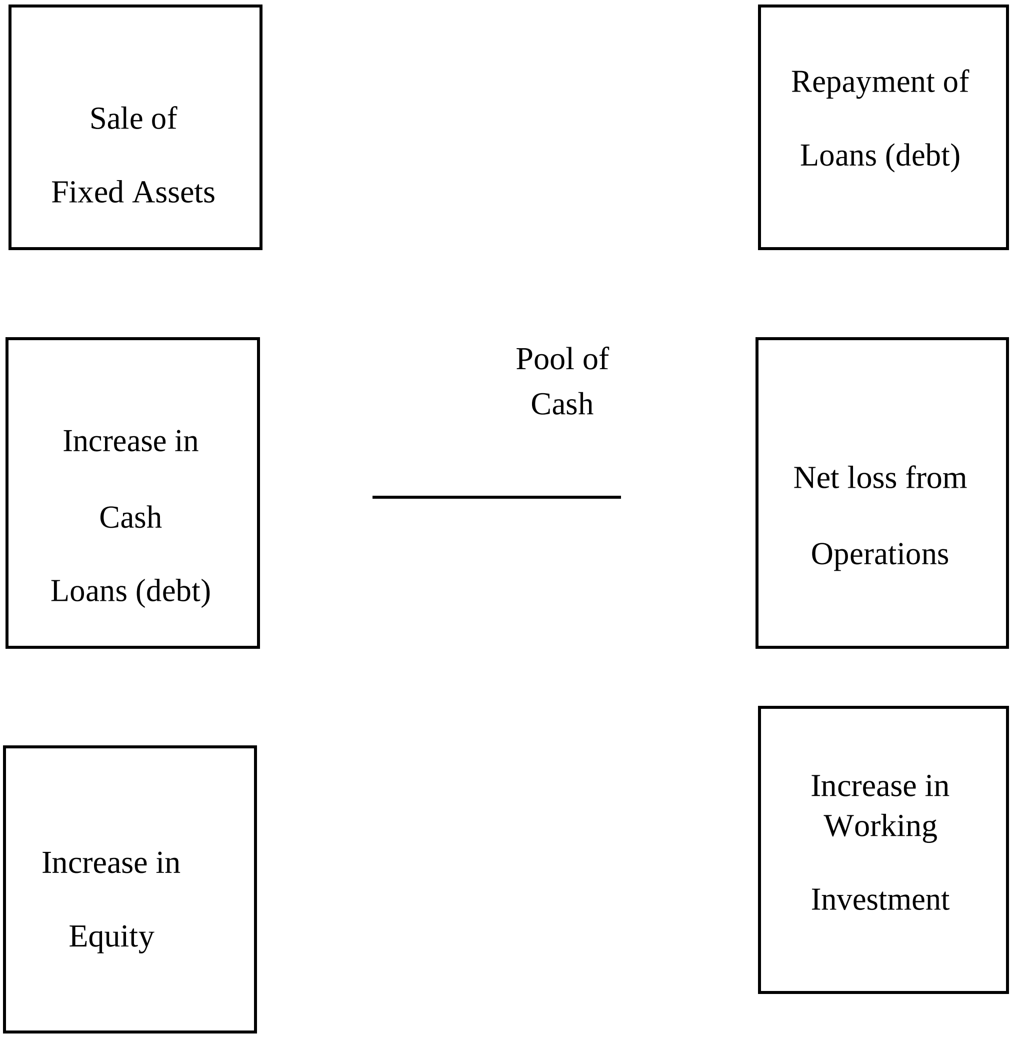


Figure 12:1 Sources and Uses of Cash

A properly prepared cash flow statement will reveal when a project will require financing because of the gaps between the earning of income and the actual receipt of cash. It will be very important for us to note that when a sale is made to a third party, an income has been earned and this should be recorded in the books of the firm. However, if the third party does not pay cash immediately for the goods or services received, then we will say that no cash inflow came in. So, a firm can be making sales but also lack money if it sells on credit.

Secondly, providers of finance (e.g. banks) are usually interested in the projected cash flow statement of the firms or projects that they are being called upon to finance. Their interest in reading the cash flow is to determine whether the borrower's project will be able to:

(1) repay loan principal
(2) repay interest and other bank charges

Thirdly, the managers of a project may be guided by a projected cash flow statement especially if the same has been prepared by a third party like a management consultant.

3.1.2 The Structure of the Projected Cash Flow Statement

At least, we now understand what the projected cash flow statement is.
It is a forecast of cash inflows and outflows of a project or a firm.

The details of all the cash inflows and the cash outflows must be captured. We will now use an example to demonstrate a projected cash flow statement. You are requested to study the example and make sure you understand same.

Example: Chisco Nigeria Limited

In December 2007, Chisco Nigeria Limited obtained a loan of N10,000,000 from a bank to start a cassava flour manufacturing plant.

Table 12.1 is a three month projected cash flow statement as prepared by the Financial Controller of Chisco Nigeria Limited.

CHISCO NIGERIA LIMITED

CASH INFLOWS	**January 2008**	**February 2008**	**March 2008**
Capital introduced	30,000,000	-	-
Loan Introduced	10,000,000	-	-
Cash sales	40,000,000	42,000,000	43,000,000
Total cash inflows	80,000,000	42,000,000	43,000,000
CASH OUTFLOWS			
Purchase of machinery	40,000,000	-	-
Raw Materials	20,000,000	21,000,000	22,000,000
Salary and wages	2,000,000	2,000,000	2,200,000
Office expenses	200,000	200,000	200,000
Electricity and gas	2,000,000	2,000,000	2,100,000
Loan repayment	-	1,000,000	1,000,000
Selling expenses	500,000	500,000	800,000
Total Cash Outflows	64,700,000	26,700,000	28,300,000
Inflows Less Outflows	15,300,000	15,300,000	14,700,000
Opening cash balance	1,000,000	16,300,000	31,600,000
Closing cash balance	16,300,000	31,600,000	46,300,000

Table 12:1 Projected Cash Flow Statement

3.1.3 Cash Inflows

From the example that we used – Table 12.1, you can see that the cash flow is broken down into two main segments namely:

(1) the cash inflows
(2) the cash outflows.

Let us now proceed to examine some of the items that make up the cash inflows.

- **Capital Introduced**

Every firm or project ideally should have a capital. At the time that a project is conceived, or being expanded, the owners usually bring in what is known as capital. This capital brought in really is an inflow of cash.

In a limited liability company, this capital will be introduced by the shareholders. They contribute the capital of the company. In a small business, a proprietor, the owner of the business, usually introduces the capital.

- **Loan Introduced**

Another item appearing in our projected cash flow statement is loan introduced. In our example, the loan introduced is N10,000,000. This obviously is an inflow of cash. You will note that the loan comes in as a single entry in the month of January 2008.

- **Cash Sales**

The sales figure is the most important in a projected cash flow statement. However, projections for sales pose problems for the analyst. In projecting for sales in the cash flow, it is only cash sales that should be entered as cash inflows. Any sale made on credit should be excluded. But then you will quickly realize that:

Total sales = Cash sales + Credit sales.

Credit sales refer to sales for which payment is not made immediately.

In the projected cash flow statement, only estimates of actual cash will be entered in the cash flow.

3.1.4 Cash Outflows

We have discussed the cash inflows. We also need to discuss the cash outflows. Cash outflows will include those items which use cash. And they will include the following:

1. purchase of machinery
2. raw materials
3. salary and wages
4. office expenses
5. electricity and gas
6. loan repayment
7. selling expenses

SELF ASSESSMENT EXERCISE

List three uses of cash.

4.0 CONCLUSION

In this unit, we discussed Cash Flow Analysis. We discussed the cash flow statement. We also discussed the users of the cash flow statement. We also used an example to show what a cash flow looks like.

5.0 SUMMARY

Cash flow analysis was treated in this unit. We also said that cash flow analysis is one of the most important aspects of project appraisal. Cash flows give a picture of cash inflows and outflows of a project.

In the next unit, we shall treat Traditional Investment Appraisal Methods.

6.0 TUTOR-MARKED ASSIGNMENT

Why do you think that banks are interested in projected cash flow statement of a project?

7.0 REFERENCES/FURTHER READING

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UNIT 15 TRADITIONAL INVESTMENT APPRAISAL METHODS

CONTENTS

1.0 INTRODUCTION

In the last unit (Unit 14), we discussed Cash Flow Analysis. We discussed the structure of a cash flow statement. We also discussed the user of the projected cash flow statement. Then we went ahead to provide a worked example of a cash flow. In this unit, we shall discuss Traditional Investment Appraisal Methods.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- describe the traditional investment appraisal methods
- extrapolate how you can use them to rank projects.

3.0 MAIN CONTENT

3.1 Traditional Investment Appraisal Methods

The firm has three decisions to make:

- the investment decisions
- the financing decisions
- the dividend decisions

Also, entrepreneurs have the investment decisions to make. So, faced with an array of investment opportunities in the market place, the central questions asked are:

(1) Given projects A, B and C, what project should be undertaken?
(2) What is the criterion for choosing project A instead of Project B?

There must be a way to appraise projects before we can be able to say that the project is acceptable or not.

Our primary task in this unit is to discuss the investment decisions and see how to arrive at accepting or rejecting the selection process. The investment decisions of the firm or the entrepreneur are various. It could involve the start up of a new cassava farm to produce ethanol. It could be the mechanization of a process or the replacement of machines. But whatever the investment is, a decision has to be made on whether or not to accept the investment.

The investment or capital budgeting decisions are very important because they involve huge capital outlays. Also, once an investment has been made, it is very difficult to reverse.

Because of all these, the firm must develop techniques for evaluating the investment proposals before it.

3.1.1 The Investment Criteria

We have already said that the investment decisions of a firm or entrepreneur are important. So, investment decisions must be made carefully. We will therefore agree that there should be a model or method for selecting which projects to select and those to reject.

The investment selection criteria that will be used must be such that they should possess certain characteristics:

- It should provide the project evaluator the simple means of distinguishing between acceptable and unacceptable investment projects.
- It should be able to assist the project evaluator to choose between alternative projects especially where there is a financial constraint.
- It should also be able to rank projects in their order of desirability.

- It should also be able to recognize the fact that bigger cash flows are more preferable to smaller ones and also that early cash flows are better than later cash flows.

- It should be applicable to any type of project.

In the literature, there are many investment criteria in use. We have the traditional investment criteria and the discounted cash flow criteria.

In this section, we are only interested in the traditional investment criteria. The two main traditional criteria that we shall discuss are the payback period and the accounting rate of return methods.

3.1.2 Pay Back Period

The payback period is one of the traditional methods used in evaluating investment proposals. Apart from the fact that it is simple, it is also very popular amongst analysts.

The payback period is defined as the number of years required to recover the original cash outlay invested in a project.
For example, if a project generates constant annual cash inflows, the payback period can be computed thus:

$$\text{Payback period} = \frac{\text{Cash outlay (Investment)}}{\text{Annual Cash Inflow}}$$

Worked Example

ABC Ltd – a transport company purchases a luxury bus for N20,000,000. The luxury bus yields annual cash inflow of N5,000,000 for the next 10 years. Calculate the payback period.

Solution

The payback period for the bus is:

$$\text{Payback period} = \frac{\text{N}20{,}000{,}000}{5{,}000{,}000}$$

$$= 4 \text{ years}$$

The example of the luxury bus that we have just used is a very simple and straight forward one. In real life, cash flows are never fixed or constant. They have no regular pattern.

In a situation of irregular, unpredictable and uneven cash flows, the payback period can be computed by adding up the cash inflows until the total cash inflows become equal to the initial cash outlay (Investment).

Example

An urban hospital requires N20,000,000 to establish and generates annual cash inflows of N4,000,000, N6,000,000, N5,000,000, N10,000,000 for the next four years. Calculate the payback period.

Solution

If we add up the cash inflows of the first three years, they amount to N15,000,000. This means that the remaining amount to be recovered is N5,000,000. In year 4, the cash inflow is N10,000,000. If the cash inflows for year 4 are even, it will take only 6 months to recover the remaining N5,000,000. So the payback period for the luxury bus is 3 ½ years.

The payback period can be used in two ways. First it can be used as an acceptance or rejection criterion. Secondly, it can be used to rank projects.

Ideally, every firm should have a maximum payback period set up by management to guide its investment decision making. For example, a firm may set 3 years as the maximum pay back period of any investment that it can undertake. What that means is that any project which has a payback period greater than 3 years will not be accepted.

Secondly, payback period can be used to rank projects. As a ranking method, pay back period gives highest ranking to a project with a shorter pay back period.

So, if a firm is constrained to choose between two mutually exclusive projects due to capital rationing, then the project with the shorter payback period will be selected.

SELF ASSESSMENT EXERCISE 1

List the three main investment decisions that the firm makes.

3.1.3 Evaluation of Payback Period

Starting from the definition of payback period, we can see that it is a relatively easy concept to understand. The payback period is simple and

also very easy to compute. It does not involve complex mathematical calculations.

Secondly, payback period is not costly. It costs less than other evaluation methods because it does not use up a lot of costly analysts' time. It does not also require the assistance of computers to compute payback period.

However, despite the fact that it is simple to use and also cheap in terms of cost, payback period is not a good investment criterion because it suffers from various obvious limitations.

Firstly, it does not take into account, the cash inflows generated after the payback period. Once the payback period of a project has been reached, no further inquiry will be made on any other cash inflows that may arise.

Secondly, since it does not consider all the cash inflows generated by a project, it is a weak criterion.

Thirdly, it does not consider the pattern of cash inflows. The pattern of cash inflow consists of the magnitude and timing. In the financial analysis, the pattern of cash inflows is very important as we know fully well that money has a time value.

We have spent quite some time to discuss the shortcomings of payback period. Despite all the weaknesses that we have highlighted, payback period has a place in the minds of project analysts. Practically, some firms still use payback period and it guides them in selecting their investment projects given an array of projects. Also, analysts are beginning to worry that the future cannot be easily determined and as such, projects with shorter payback period should appeal to investors and management alike.

Even at that, at the rudimentary level of business, the emphasis of an investor is on early recovery of the investment outlay. We have discussed the concept of payback period. Next, we shall discuss another traditional investment criterion known as the Accounting rate of return method.

3.2 Accounting Rate of Return Method

We have just discussed the payback period as a traditional investment criterion. We are now taking a look at the Accounting rate of return method.

The Accounting Rate of Return (ARR) method uses accounting information to measure the profitability of an investment proposal.

The accounting rate of return is calculated by dividing average income after taxes by the average investment. Average investment is equal to original investment plus salvage valued divided by two (2).

Thus the accounting rate of return is given by the following:

$$ARR = \frac{\text{Average income}}{\text{Average investment}}$$

We shall use a rural poultry farm to demonstrate the computation of the accounting rate of return. But before we do that, we shall first briefly look at two concepts which will assist us to understand fully the accounting rate of return method.

- **Depreciation**

Depreciation is a non-cash expense item. Depreciation is the allocation of cost of the fixed assets used in a business. It involves an accounting entry and does not involve any outflow of cash. But, depreciation is usually charged to the profit and loss account because it is an accounting way of matching costs of fixed assets with the benefits. For example, a firm purchases a lorry for its transportation of raw materials. The lorry may cost for example N5,000,000 but the useful life may stretch for over 10 years. It makes sense that every year of its use, it provides benefits to the firm.

- **Salvage Value**

Salvage value can be seen from two angles. The first is the cash salvage value. Cash salvage value of an investment or asset is the market price of the investment or asset at the end of its life. On the other hand, book salvage value is the cost of the machine or asset at the end of its life. In the accounting rate of return method, the book salvage value is usually used as we shall shortly see.

Worked Example

A rural poultry farm costs N5,000,000 to set up and has a scrap value of N1,000,000. Its stream of income before depreciation and taxes during the first five years is N1,000,000, N1,200,000, N1,400,000, N1,600,000 and N2,000,000. If depreciation is on straight-line basis and tax rate is 50%, calculate the accounting rate of return (ARR).

Solution

Computation of the Accounting Rate of Return

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Earnings before depreciation & taxes	1,000,000	1,200,000	1,400,000	1,600,000	2,000,000
Depreciation	800,000	800,000	800,000	800,000	800,000
Net earnings before taxes	200,000	400,000	600,000	800,000	,200,000
Taxes at 50%	100,000	200,000	300,000	400,000	600,000
Book Value of Investment					
Beginning	5,000,000	4,200,000	3,400,000	2,600,000	1,800,000
Ending	4,200,000	3,400,000	2,600,000	1,800,000	1,000,000
Average	4,600,000	3,800,000	3,000,000	2,200,000	1,400,000

Average earnings after taxes =N100,000+N200,000+N300,000+ N400,000+600,000 5

= **N320,000**

Average investment=
N4,600,000+N3,800,000+N3,000,000+N2,200,000 N1,400,000
5

= N3,000,000

$$\text{Accounting rate of return} = \frac{\text{Average income}}{\text{Average investment}}$$

$$= \frac{\text{N320,000}}{\text{N3,000,000}}$$

Accounting rate of return = 10.666%

SELF ASSESSMENT EXERCISE 2

List four public sector projects in your neighbourhood.

Under the accounting rate of return method, the acceptance or rejection rule is to accept those investment proposals which ARR is higher than the minimum rate established by management. Also, the investment proposals which ARR is lower than the minimum rate established by management will be rejected.

3.2.1 Evaluation of ARR Method

One of the major advantages of the accounting rate of return method is that it is relatively easy to use. It can be easily calculated using accounting data. It uses accounting profits to measure the rate of return. Although the ARR is relatively easy to use, it suffers from the two main serious disadvantages.

Firstly, it ignores the time value of money. By so doing, profits occurring at different times are given the same value and of course that is very wrong.

Secondly, it uses accounting profits, not cash flows, to appraise investment proposals. It is incompatible with the firm's objective of maximizing the market value of shares. This is because share values depend on cash flows, earnings and not upon accounting rates.

4.0 CONCLUSION

In this unit, we discussed Traditional Investment Appraisal Methods. We discussed Payback Period Method and the Accounting Rate of Return Method (ARR). Both are Traditional Investment Appraisal Methods.

5.0 SUMMARY

This unit treats Traditional Investment Appraisal Methods. We discussed two of the methods – Payback Period and Accounting Rate of Return. These methods are very simple to use and therefore appeal to project analysts.

In the next unit, we shall treat Discounted Cash Flow Methods of Investment Appraisal.

6.0 TUTOR-MARKED ASSIGNMENT

A hospital costs N5,000,000 to set up and generates year end cash flows of N1,000,000, N1,500,000, N2,000,000, N3,000,000 The cost of capital is 10%. Calculate the net present value of the hospital investment.

7.0 **REFERENCES/FURTHER READING**

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UNIT 16

DISCOUNTED CASH FLOW METHODS OF INVESTMENT APPRAISAL

CONTENTS

1.0 INTRODUCTION

In the last Unit (Unit 3), we discussed Traditional Investment Appraisal Methods. We discussed the Payback Period, one of the traditional methods of Investment Appraisal. We then discussed Accounting Rate of Return (ARR).

In this unit, we shall discuss the Discounted Cash Flow Methods of Appraisal. It is fairly difficult to understand. But you need to understand it all the same.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- describe the concept of the discounted cash flow Methods of Investment Appraisal
- discuss their practical relevance.

3.0 MAIN CONTENT

3.1 Discounted Cash Flow Methods of Investment Appraisal

Payback Period and the Accounting Rate of Return (ARR) were defective as Investment Appraisal methods.

A main reason advanced was that both methods failed to recognize the time value of money. Because of that shortcoming, we will improve our analytical skills by discussing alternative investment appraisal methods that recognize the time value of money. The two methods are the Net Present Value (NPV) method, and the Internal Rate of Return (IRR) method. As a group, they are known as the discounted cash flow methods. Our task in this unit is to discuss them. However, we will first discuss two topics that will assist us to understand the discounted cash flow methods of project and investment appraisal. The two topics are time value of money and the cost of capital.

3.1.1 Time Value of Money

In most of our discussions concerning money, we usually treated money in absolute terms. We did not consider time when computing the value of money. For example, a student may not easily see the difference between N50,000 bursary advanced to him in January 2008 or December 2008. Technically speaking, a sum of N50,000 in January 2008 is not the same as N50,000 in December 2008 because of what is known as "the time value of money". And truly speaking, the two sums of money do not have the same value.

In terms of rationality, a rational person who is offered to collect the sum of N3,000,000 in January 2008 or December 2008 would prefer to collect the sum of money in January 2008 instead of December 2008 due to the following reasons:

- The future is uncertain and anything can happen to cancel the opportunity of receiving the money later.
- The desire to spend now instead of later
- The money could be invested immediately to earn interest.

We will now say that this attitude of preferring money now instead of the future is known as an individual's time preference for money.

Apart from this time preference for money, there is also the time preference rate. In the literature, the time preference for money is usually expressed by an interest rate. This interest rate is usually known as the time preference or discount rate. The discount rate is very

important in the investment analysis because different firms have their own discount rates.

Before we go further, there is this concept that we would like to introduce to help our further analysis. This concept is the Cost of capital.

3.1.2 The Cost of Capital

In the investment analysis and appraisal, the cost of capital appears to be very critical and important.

The major reason for wanting to know the cost of capital is that it helps the analyst to make intelligent financial decisions when there are two options namely:

- accept a project
- reject a project

So we will go ahead and define the cost of capital as the minimum rate of return required on an investment project. It is a cut-off rate of return. There is also what we call the expected rate of return on an investment.

These two rates may not be equal.

Truly speaking therefore, the firm will undertake the investment proposal if the expected rate of return is greater than the cost of capital.

Usually, when appraising the investment proposal, the cost of capital will be given.

3.1.3 The Net Present Value (NPV) Method

The Net Present Value method is the most admired among the discounted cash flow methods. This is because it is relatively easy to compute and also recognizes the time value of money. Inherently, it correctly advances the view that cash flows that arise at different periods have different values.

When you want to compute Net Present Value (NPV), three steps are very important.

Firstly, an appropriate rate of interest is selected which will be used to discount the cash flows. This rate of interest is the firm's or project's cost of capital.

Secondly, the present values of investment proceeds (inflows) are computed and the present values of investment outlay (outflows) are computed using the cost of capital as the appropriate discount rate.

Thirdly the Net Present Value (NPV) is computed by deducting the present value of cash outflows from the present value of cash inflows. If the present value of cash inflows is greater than that of outflows, then the project has a positive Net Present Value (NPV). However, if the present value of cash inflows is less than the present value of cash outflows, then the present value of the investment proposal will be negative.

Assuming that all cash outflows of an investment are made in year to then the equation for the Net Present Value is given by:

$$NPV = \left(\frac{A1}{(1+k)} + \frac{A2}{(1+k)2} + \frac{A3}{(1+k)3} + \ldots + \frac{An}{(1+k)n} \right) - C$$

Where A1, A2 … + + An = cash inflows
K = the firm's cost of capital
C = cost of the investment proposal
n = expected life of the investment proposal

Under the net present value method, the acceptance rule is to accept the investment proposal if the Net Present Value is positive and to reject it if the Net Present Value is negative.

Worked Example

A bakery project costs N2,000,000 to set up and generates year end cash inflows of N800,000, N900,000, N1,000,000 and N800,000 over a four year period. The required rate of return is 10%. Calculate the net present value of the bakery project.

Solution

Year Value	**Cash Inflow (₦)**	**Discount factor at 10%**	**Present Value Of Cash Inflow (₦)**
1.	800,000	.909	727,200
2.	900,000	.826	743,400
3.	1,000,000	.751	751,000
4.	800,000	.683	2,768,400
		Less Project Cost	2,000,000
		Net Present Value	768,000

3.1.4 Interpretation of Net Present Value (NPV)

We have used the example of the bakery project to compute Net Present Value (NPV). But we need to understand what NPV is and be able to interpret it. The positive net present value may be interpreted as the immediate increase in the firm's wealth if the investment proposal is accepted. It is equivalent to an unrealized capital gain. The unrealized capital gain will be when the expected cash inflows materialize.

3.1.5 Evaluation of Net Present Value Method

We have discussed the net present value concept and used an example to compute the NPV of a project. We shall go ahead to evaluate NPV method. The most important merit of the NPV method is that it recognizes the time value of money. Also, it considers all the cash flows that arise throughout the duration of the investment project. The NPV method is consistent with the objective of maximizing the objective of the firm.

However, the net present value method suffers from some limitations. Firstly, it is difficult to use. It involves the use of discount tables and also computers.

Secondly, in calculating NPV, it is assumed that the appropriate discount rate is known. The discount rate to be used is the firm's cost of capital. The cost of capital is not very easy to compute.

The NPV method may not give satisfactory answers when the projects in question have different initial outlays. NPV result may be misleading when we are dealing with alternative projects – under capital rationing situations.

3.2 The Internal Rate of Return (IRR) Method

We have discussed the net present value method and did a computation of NPV. We shall now discuss the Internal Rate of Return (IRR) method. The internal rate of return is another discounted cash flow technique which recognizes the time value of money and apparently the magnitude and timing of cash flows. The Internal Rate of Return (IRR) can be defined as that rate which equates the present value of cash inflows with the present value of cash outflows of an investment. At that rate (IRR), the net present value of cash outflows of an investment is zero (0). It is called an internal rate because it depends entirely on the outlays and inflows of the investment and not any other rate outside the investment.

If we write the equation:

$$C = \frac{A1}{(1+r)} + \frac{A2}{(1+r)^2} + \dots \frac{An}{(1+r)^n}$$

Where C = investment outlay

A1 + A2 ++… An = Cash inflows

$$\text{Then } O = \frac{A1}{(1+r)} + \frac{A2}{(1+r)^2} + \dots \frac{An}{(1+r)^n} - C$$

The value of r in the equation where the cash inflows and the investment outlay is zero is known as the internal rate of return. Under the Internal Rate of Return (IRR) method, a project is accepted if the internal rate of return is higher than or equal to the minimum required rate of return. This minimum required rate of return is known as the firm's cost of capital.

3.2.1 Interpretation of IRR

The interpretation of IRR is that it is the highest rate of interest that a firm will be ready to pay on the funds borrowed to finance a project without being financially worse off after repaying the principal and interest. In a technical sense, the IRR is the break-even rate of borrowing from a bank. Obviously, if a firm is able to borrow at a rate lower than the internal rate of return, the investment project will be profitable.

3.2.2 Measurement of Cash Flows

In the earlier section of this unit, we discussed two of the discounted cash flow methods – the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods. And we saw that the two methods used information on cash flows for the investment analysis.

In discussing both methods, we discussed cash inflows and cash outflows. But at this point in time, we are going to take a technical look at cash flows and make sure we understand how they are used in the investment analysis.

A lot of students do confuse profit and cash flows. So, we must first draw a line between the two. Changes in profits may not lead to changes in cash flows. Increase in profit may be tied up in credit sales with no increase in cash flow. So, a firm may be very profitable but at the same time will be experiencing severe cash flow problems.

So, it is to be stated that in the investment analysis, it is the inflows and outflows of cash that is important. In an ideal situation, the receipt of cash is a clearly defined corporate objective.

3.2.3 Depreciation and Cash Flows

In computing cash flows, the net cash flow is usually on an after-tax-basis. That is to say that taxation should be deducted before arriving at the net cash flow. In the computation of after-tax net cash flows, the treatment of non-cash items deserves special treatment. One of those non-cash items is depreciation. Depreciation is a way of allocating cost of fixed assets. In accounting, depreciation is usually charged to the profit and loss account as a way of matching cost of fixed assets with their benefits. Depreciation however does not involve any outflow of cash. So, depreciation is usually ignored in cash flow computation. In a situation where depreciation has been deducted before arriving at profit after tax, the ideal is to add back depreciation to arrive at after tax net cash flow.

Worked Example

Below is the projected income statement of Fellowship Aluminum Limited. Compute the net-cash flow after taxation.

Note: The company has an outstanding loan for which it pays N10,600,000 per annum.

Projected Income Statement

Fellowship Aluminum Limited

Year Ending	31/12/2007 (N)
Revenue	
Sales revenue	839,280,000
Direct Cost of Production	
Production raw materials	567,927,360
Electricity and gas	6,880,000
Repairs and maintenance	500,000
Depreciation of machinery	3,346,000
Total Direct Costs	578,653,360
Indirect Costs	
Management and Labour	2,508,000
Interest and bank charges	3,000,000
Selling expenses	7,250,000
Insurance of assets	50,000
Total Indirect Costs	12,808,000
Total direct + indirect costs	591,461,360
Profit before taxation	247,818,640
Taxation	74,000,000
Profit after taxation	173,818,640

Solution

Projected Cash Flow Statement – Fellowship Aluminum Limited

CASH INFLOWS	₦
Profit before taxation	247,818,640
Add back depreciation	3,346,000
Total cash inflows	251,164,640
CASH OUTFLOWS	
Loan repayment	10,600,000
Taxation	74,000,000
Total Outflows	84,600,000
Cash inflows less cash outflows	166,564,640
Opening cash balance	-
Closing cash balance	166,564,640

3.2.4 Fixed Assets and Cash Flows

After treating depreciation, another item which we need to understand properly is fixed assets. What we are really interested in is the treatment of purchase of fixed assets. In the cash flow analysis, when an asset is purchased, the purchase cost is treated as an outflow.

3.2.5 Salvage Value and Cash Flows

When we talk of salvage value, we are talking of the estimated value of an asset at the completion of its useful life for the firm. Normally, salvage value is of two types namely:

- Book salvage value is the cost of the asset at the end of its useful life.
- Cash salvage value is the market value of the asset at the end of its useful life.

SELF ASSESSMENT EXERCISE

List four expense items that you consider as cash outflows in a firm's profit and loss account.

4.0 CONCLUSION

In this unit, we have discussed cash flow criteria. We discussed the Net Present Value (NPV) and the Internal Rate of Return (IRR).

5.0 SUMMARY

In this unit, we have treated discounted cash flow criteria which we saw are more sophisticated than the traditional criteria. We also discussed cash flows.

In the next unit, we shall discuss Economic Appraisal and Evaluation of Projects.

6.0 TUTOR-MARKED ASSIGNMENT

Net Present Value (NPV) method is an investment appraisal method.
Discuss the method.

7.0 REFERENCES/FURTHER READING

Leon Ikpe (1999). *Project Analysis and Evaluation*. Lagos: Impressed Publisher.

Pandey, I. M. (2002). *Financial Management.* (8th ed) New Delhi: Vikas Publishing House; PVT Ltd.

UNIT 17 ECONOMIC APPRAISAL AND EVALUATION OF PROJECTS

CONTENTS

1.0 INTRODUCTION

In the last unit (16) we discussed Discounted Cash Flow Methods of Investment Appraisal. We discussed the Net Present Value (NPV) method and the Internal Rate of Return (IRR) method.

In this unit, we shall discuss Economic Appraisal and Evaluation of Projects.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of economic appraisal
- describe economic appraisal and evaluation.

3.0 MAIN CONTENT

3.1 Economic Appraisal and Evaluation of Projects

Generally, in the analysis and evaluation of a project, we focused mainly on the cash inflows and the cash outflows. Here, we tried to analyse critical income flows of a project. We also tried to evaluate critical expenditures of a project. The type of analysis we conducted basically focused attention on private sector projects. Financial analysis tries to provide only a micro view of a project and concentrates mainly on trying to estimate accounting profits. The private sector is usually

interested in profits. However, if we are evaluating private sector projects, we will not be conducting financial analysis rather, we will be conducting what is known as economic analysis.

Economic analysis tries to consider and evaluate projects from a macro view point as opposed to financial analysis that views projects from micro view point. Economic analysis seeks to evaluate projects from the larger society's point of view.

The types of questions economic analysis tries to answer are:

(1) Will the project under consideration lead to general well being of the community, the State and Nigeria as a whole?
(2) Will the project generate employment at various levels in the Nigerian economy?
(3) Will the project lead to economic growth and development?
(4) What are the linkages that the project has forward or backward linkages?
(5) Will the project generate more technical knowledge?

The questions that we have asked are not exhaustive. But rather, they are used here to demonstrate the type of questions that economic analysis seeks to answer.

3.1.1 Financial and Economic Analysis (A Comparison)

To make sure that we fully understand what economic analysis is, we will try to compare it with financial analysis.

In the general theory, financial analysis tries to solve resource allocation problems. It tries to use financial information from projects, to determine whether or not to embark on a particular project. On the other hand, economic analysis also tries to solve resource allocation problems in an economy. In the economic theory, resources are known to be very scarce and it is part of any good analysis to allocate resources between competing projects. In a public sector setting for example, resource allocation problems can arise if a community is trying to decide whether to build a school or a hospital with its limited resources.

Financial analysis also, as we said, tries equally to allocate resources. But this is from a micro point of view. In a sense therefore, both financial analysis and economic analysis solve resource allocation problems.

Financial analysis also focuses attention on issues of benefits and costs arising from a project: streams of costs are evaluated and then deducted

from the streams of benefits. If the streams of benefits are greater than the streams of costs, then the project will be accepted.

However, if the streams of benefits are lesser than the streams of costs, then the project will be rejected. Economic analysis also is concerned about the costs and benefits attached to a project. If the streams of benefits are greater than the streams of costs, then the project in question has a positive value and should be accepted. However, if the streams of costs are greater than the streams of benefits, then the project under consideration has a negative value and should be rejected.

We now assert that financial analysis and economic analysis both concern themselves with costs and benefits attached to a project. They both provide the project analyst with answers as to the question of whether or not to accept a project under consideration. In their analysis, both use discounting and compounding techniques to arrive at their answers.

However, despite the similarities between them, there exist conceptual differences between financial analysis and economic analysis. A major difference is that while financial analysis has the primary objective of establishing the viability and acceptability of a project, paying no attention to society, economic analysis has the objective of establishing the fact that, a project is acceptable or not to the society as a whole.

Also in reaching the critical decision of whether or not to accept a project, financial analysis and economic analysis differ in their description of what constitutes costs and benefits arising from a project.

For example, in financial analysis, costs and benefits arising from a project are usually defined in monetary terms such as profits. But economic analysis goes beyond the monetary variables such as profits.

Economic analysis tries to define costs in terms of opportunity costs or foregone costs to the society as a whole.

3.1.2 The Nature of Economic Analysis

In economic analysis, the costs and benefits attached to a project are usually compared before a decision can be reached on whether or not to accept a project.

- **Net Present Worth**

Net Present Worth is the difference between present worth of benefits and present worth of costs. We can write thus:

Net Present Worth = $\boxed{\text{Present Worth of benefits}} - \boxed{\text{Present worth of costs}}$

Generally, according to the Net Present Worth theory, a project is acceptable if the net present worth is positive. If the net present worth is negative, the project will be rejected.

· **Benefit-Cost Ratio**

If you divide the present worth of benefits of a project by the present worth of its costs, then you have what is known as the benefit-cost ratio.

We can write thus:

$$\text{Benefit-Cost ratio} = \frac{\text{Present Worth of Benefits}}{\text{Present Worth of Costs}}$$

Generally, a project is acceptable if the benefit-cost ratio is greater than 1 (one).

If benefit-cost ratio is exactly 1 (one) then that project is a marginal project or a break even project.

· **Internal Rate of Return**

Internal rate of return is a discount rate where the present worth of benefits is equal to the present worth of costs.

Under the internal rate of return evaluation method, a project will be acceptable if its internal rate of return is higher than the firm’s required rate of return.

The starting point of economic analysis is the financial analysis of projects which should be properly concluded before embarking on economic analysis. Some adjustments will be made to the financial calculations to arrive at the economic data.

Firstly, it may be very necessary to include or exclude some costs and benefits which may have been included or excluded from the financial analysis.

Secondly, some project inputs and outputs may have to be revalued if their shadow prices differ significantly from their market prices.

SELF ASSESSMENT EXERCISE

Name three methods of evaluating the worth of a project.

3.1.3 Adjustments to Financial Analysis

We have stated that the starting point of economic analysis is financial analysis, so if we have financial data on financial analysis, we need to make some adjustment to the financial analysis to arrive at economic analysis data.

We shall now consider some of the adjustments.

- **Transfer Payments**

Transfer payments represent transfer of resources from one section of society to another. They do not make any claim on the country's resources and as such, their impact should be clearly distinguished and analyzed in the economic analysis.

One of the first transfer payment we shall consider is interest. Interest is a reward for capital. For example, if a project is funded through bank loan, the interest component is included in the profit and loss statement.

The interest charges in the profit and loss statement, represent transfer payments from a project to the provider of funds. What the project has lost (interest) has become a gain to the provider of funds.

In effect, both figures are equal and cancel out without any net increase. Therefore in economic analysis, interest charges are excluded since they only represent transfer payments.

The second transfer payment we shall consider is taxes. When a project is profitable, it is expected to pay taxes to the government at the ruling rate. In computing the profit of a project, taxes are deducted to arrive at net profit. Taxes therefore appear as outgoing cash flows.

Taxes represent transfer payments from a project to government.

In economic analysis of a project, taxes are excluded because from the point of view of the society, they are only transfer of resources from one section of the economy to another.

The third transfer payment we shall consider is subsidies. In a traditional private sector setting, it would be unheard of to talk of subsidies. But in economic analysis, subsidies appear as important data.

Most public sector projects enjoy government subsidies to enable the poor gain access to certain services which ordinarily they cannot afford without government assistance. Subsidies represent opportunity costs to a nation as a whole. So, we say that in estimating the true cost of a project in economic analysis, subsidies should be included.

3.1.4 Linkage Effects of a Project

We will now discuss the concept of linkage effects of a project. And to do that, we will consider a situation where a polytechnic is newly located in an environment. Many new investments will begin to spring up. Private hostels will begin to spring up driven mainly by the profit motive. Restaurants will spring up and so will hair dressing salons all to cater for the needs of the new polytechnic. A bank may even arrive on the scene. Such are the linkage effects of a project.

Basically, there are two types of linkage effects and we will go ahead to discuss them.

- **Forward Linkage Effects**

Forward linkage generally is the stimulus given to industries that use the products of a project. Consider for example a flour manufacturing plant that is newly located in an environment. Because flour has so many uses, it can give rise to bread manufacturing factories and other businesses that use flour. This is a case of forward linkage project.

- **Backward Linkage Effects**

Backward linkage generally demonstrates the stimulus given to industries that supply the inputs to a project. For example, the establishment of a flour mill in an environment will lead to the demand for wheat which is a major input for flour mills. The flour mill will lead to investment in the cultivation of wheat. Also, the establishment of car assembly plant will lead to the establishment of tyre manufacturing plants that need to supply tyres to the car assembly plant.

All these are examples of backward linkage.

A Global Example of Economic Analysis

In 1986, the World Bank was considering the desirability or otherwise of assisting Nigeria set up a rice farm covering thousands of hectares in a rice producing area of Nigeria. Under the scheme, farmers will be allocated large hectares of land for cultivation of rice at a subsidized rate to encourage the farmers. Such things like fertilizers will be heavily

subsidized while technical advice will be provided by world bank experts and Nigerian agricultural experts. The forecast life span of the project is five years after which it is expected that diminishing returns will set in.

A financial analyst forecasts that the following is the incremental cash balances that will accrue to the farmers.

Year	Amount
1	-N300,000
2	+N600,000
3	+N700,000
4	+N800,000
5	+N900,000

The subsidies to the farmers in the 5 years is expected to be as follows:

Year	Amount
1	N50,000
2	N50,000
3	N30,000
4	N50,000
5	N60,000

Although technical advice is to be provided by world bank experts and their Nigerian counterparts, below is the value of the technical advice when reduced to monetary naira values.

Year	Amount
1	N40,000
2	40,000
3	60,000
4	30,000
5	20,000

Because the farmers are expected to pay tax as other citizens do, the financial analyst in arriving at the incremental cash balances due to the farmers already had deducted the tax due from them. The estimates of taxation are reproduced below.

Year	Amount
1	- N10,000
2	N60,000
3	N70,000
4	N80,000
5	N90,000

The cost of the rice project initially is N1,000,000 to enable the project take off. Although the lending rate for agricultural projects is 9%, it is considered that the real opportunity cost of capital is 13%.

Should the project be acceptable?

Solution

Although a variety of methods exist to appraise the project, the most favoured method is the net present worth method as earlier explained.

$$\text{NET PRESENT WORTH} = \left|\begin{array}{l}\text{Present Worth}\\ \\ \text{of benefits}\end{array}\right| - \left|\begin{array}{l}\text{Present Worth}\\ \\ \text{of costs}\end{array}\right|$$

(a) Subsidies represent outflows of cash to the economy as a whole and so constitute costs of the projects. They now appear as negative entries to denote cash outflow.

(b) Taxation is added back because it represents a transfer payment from the farmers to the government. It is to be recognized that the taxes arise because of the rice project. The negative tax entry in year one is the tax foregone as a result of the rice project.

(c) Technical advice also constitutes a use of resources and has to be clearly recognized as an outflow of resources.

Economic Analysis of World Bank Assisted Rice Project

Net present worth at 13%

(Amount in Naira)

Year	Incremental Cash Balances due to Farmers	Subsidies	Taxes	Value of Technical Advice	Investment	Incremental Benefits (Cashflows)	Discount Factor 13%	Present Worth
1	-300,000	-50,000	-10,000	-40,000	-1,000,000	-1,400,000	.884	-1,237,600
2	+600,000	-50,000	+60,000	-40,000	-	+570,000	.783	+446,310
3	+700,000	-30,000	+70,000	-60,000	-	+680,000	.693	+471,240
4	+800,000	-50,000	+80,000	-30,000	-	+800,000	.613	+490,400
5	+90,000	-60,000	+90,000	-20,000	-	+910,000	.542	+493,220
Total	+2,700,000	-240,000	+290,000	-190,000	-1,000,000	+1,560,000		+663570

Project has positive Net Present Worth and should be accepted.

Steps in Economics Analysis

(1) Prepare financial analysis of a project using market prices and taking into consideration items like taxation and interest charges.

(2) Examine the entries in the financial analysis that are transfer payments and adjust such items. It follows that items like taxation which have already been deducted from the financial statement will have to be added back to estimate the benefits of the projects. The adjustment will affect such items like interest charges and subsidies.

(3) If market prices differ from the shadow prices of inputs, adjust the input prices to reflect the true opportunity cost of inputs.

(4) Estimate the adjusted incremental benefits arising from the project.

(5) Using the discount rate chosen, estimate the present worth of the project benefits on a year to year basis taking into consideration the initial outlays of the project.

(6) Using any of the measures of testing project worth, appraise the project to determine the acceptability or otherwise of the project.

(7) Examine the externalities arising from the projects, clearly distinguishing between positive and negative externalities.

(8) Examine the forward and backward linkage effects of the project bearing in mind the employment generation capacity of the macro project.

(9) Estimate foreign exchange savings arising from the project especially where project will use local raw materials which hitherto have been imported.

(10) Evaluate the employment generation potential of the project. It is to be noted that if a project leads to a forward project to capture the total employment potential due to the first project, cognizance should be taken of the spill-over effect.

4.0 CONCLUSION

In this unit, we discussed Economic Appraisal and Evaluation of Projects. We discussed the general nature of economic analysis.

5.0 SUMMARY

Economic Appraisal and Evaluation provide us with the tools to conduct economic appraisal of projects. Financial analysis is the private sector's view of a project without considering the project's impact on the society. On the other hand, economic analysis is a macro view of a project, taking into consideration the project's impact on the society.

6.0 TUTOR-MARKED ASSIGNMENT

What do you see as basic differences between financial analysis of a project and economic analysis of a project?

7.0 REFERENCES/FURTHER READING

Leon Ikpe (1991). *Project Analysis and Evaluation*. Lagos: Impressed Publishers.