UNIT 8 FINANCIAL MANAGEMENT OF SMALL BUSINESS

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8.0 OBJECTIVES

After going through this unit, you should be able to:

- help your client to underline and appreciate the relevance of a business plan;
- help your client prepare a business plan;
- guide your client to assess his working capital requirement;
- carry out the appraisal of the business plan prepared by your client;
- facilitate your clients in accessing the credit system available, if needed; and
- describe how to maintain their records and the books of accounts.

8.1 INTRODUCTION

It is commonly believed that financial management is a technical discipline. However, one may gradually realised that it is nothing more than common sense. Anybody willing to think logically can learn the basics that might help in establishing and managing the business venture on sound lines. It has been found that the small entrepreneurs usually do not prepare long-term plans. They often believe that their ideas cannot be implemented for want of resources. However, this may be due to inadequate understanding of the intricacies of business and lack of proper planning. Usually they learn from their own mistakes, and in the process many of them burn their fingers and get disheartened in the beginning.

Even if they know their job and the business skills, they are not able to record their activities and plans with ease. In the absence of proper accounts and records they are not able to reflect upon the past mistakes. Quite often, in the absence of records, access to formal credit facilities is also denied. So it is important for them to learn and adopt the principles of financial management, as well as maintain the necessary records. You may emphasize with your clients that whatever business they choose, the same basic principles would apply. Any business activity can be related, planned and appraised with the concepts explained in the subsequent sections of this unit.

8.2 NEED FOR A BUSINESS PLAN

Before starting any enterprise, your client has to observe, analyse and learn a lot. You must realise that conducting a business involves a complex interplay of many events and forces, which should be understood beforehand by anyone willing to start and operate a business.

The entrepreneur has to internalise and develop various desired competencies. Scanning of analysing the environment might bring out several business opportunities to choose from. This choice can be made on several counts like current demand and likely future scenario; the aptitude, knowledge and skills of the entrepreneur; available resources, etc. Thereafter, the information on product range, processes involved, various requirements of key inputs like technology, machinery, materials, manpower, etc. has to be gathered and a detailed study of the market needs to be undertaken. This enables the potential entrepreneur to be equipped for a successful launch of the enterprise. However, before this, all the information gathered has to be arranged in a typical format, often called **Project Report** or **Business Plan.** In this section, we shall look at the inputs that must go into any Business Plan or a Project Report.

Even the simplest and smallest business venture needs meticulous planning on the part of the entrepreneur. Whether your clients intend to be household artisans, small vendors, service providers, or petty shopkeepers they would need to plan their activities before launching the business. It is generally found that the small entrepreneurs often do not record their business plans and thus are not able to monitor their own progress. In the process, mistakes are repeated and the entrepreneur remains at loss to understand the real problems. Therefore, you must emphasise upon your clients that they must prepare a Business Plan so as to take a firm view of the prospective business and to decide on a concrete plan of action. This will help in monitoring, analysing and assessing the likely results of the enterprise over a period of time.

8.3 PREPARING BUSINESS PLAN

We should be very clear that the entrepreneur him/herself is the best person to prepare the business plan. For every person wanting to venture into business, preparing a business plan is an opportunity to test his/her own knowledge and perceptions about the chosen activity. You would often find with your clients that the prospective entrepreneur may not be thorough with his/her ideas. It might, therefore, be useful to gather more information and utilize more time before taking the plunge into the world of business. But the benefits attached with the process far outweigh the efforts. So let your clients make sincere attempts to prepare business plan, so as to reap the rewards at later stages. For any proposed business activity, the plan can be prepared by asking certain questions. The answers to these questions will take the shape of a Business Plan. The following suggestive format can help in this exercise.

Sl. No.	Key questions	Aims to know
1.	What are you going to make? On what scale? What will it be used for?	Product Capacity Applications
2.	Who are the customers? What exactly do they need? Will your product sell? How? At what price it will sell? Who are the competitors? How much do they sell? What will be the estimate of demand and supply in next 4-5 years?	Market Needs and wants Strategy Pricing Competitors Competition Demand-supply Estimate
3.	How will the product be manufactured? How will you arrange to secure knowledge to produce it?	Production Process and technical arrangement
4.	What machinery or equipments are required to manufacture the product? How much will such machinery produce? Are there equipments, which will remain idle? Are there equipments that will pose bottlenecks in achieving the final growth of output? Who are the suppliers of machinery? At what price will they supply? How long will they take to deliver?	Plant and machinery Capacity Capacity utilisation Critical components Suppliers Cost Delivery schedule
5.	What is the requirement in terms of land and built-up area? How much will that cost?	Land and building Cost estimate
6.	How much electricity, fuel, water and steam are required to produce at full capacity? How much will it cost to arrange for their supply in the first instance and later for their consumption?	Utilities Cost of utilities
7.	Will the project entail liquid effluent or air-pollution? What is the type of equipment to be installed and process to be adopted to cope with the problem?	Pollution, if any Pollution control equipment
8.	Where will the manufacturing facility be located? Have you looked into the right questions before selecting your location?	Location Critical factors
9.	What is the requirement in terms of raw materials, stores, consumables and packing material? How easily are all these available? What are the supply-sources? What is the cost of these materials? Whether the supply has a seasonal pattern?	Raw material Availability Sources Cost Seasonality
10.	What is the manpower need? (skills, number, education) Is the required manpower easy to get? What salary/wage will have to be paid?	Manpower Availability Cost
11.	What will be the total cost of setting up the enterprise?	Project cost
12.	What is the amount of money required to keep the business running, once the enterprise is set up? How much of such amount will change as the level of business grows over the years?	Working capital Cash flow
13.	What subsidies and concessions will the government or other organisations provide for meeting project cost and later for running the enterprise?	Financial incentives
14.	What are the various sources from which money will be raised to meet the project cost? How much money will be raised from each source?	Means of finance Funding arrangements
15.	How will business build up over the years?	Growth plans
16.	What will be the annual flow of income and expenditure and profit over the years? What will be the tax-burden?	Income expenditure and profitability projection
17.	What will be the annual flow of net cash?	Cash flow projection
18.	Will it be possible to repay the term loan? How strong is the cash profit estimate in relation to term loan repayment responsibility?	Repaying capacity Debt service coverage
19.	What is the break-even level, at which the enterprise will make neither profit nor loss? What will happen to profitability if some critical assumptions do not come true?	Risk analysis Sensitivity analysis
20.	What will be a realistic time schedule for carrying out individual tasks pertaining to project-implementation (setting up of enterprise)? What will be the total time frame for implementation?	Implementation schedule Time schedule
21.	What are the important statutory formalities, which the enterprise must fulfil prior to commencement of production?	Statutory formalities
22.	How competent you are to manage this business? At what stages you will require the support of others?	SWOT analysis of self Outside support required

Note : It would help if you could get your clients to fill up the above Proforma in relation to the business idea they have chosen or identified for themselves while going through Unit 6. The Proforma can later be refined as the entrepreneur gathers more information. To be able for you to understand a few concepts cited in this Proforma, we shall present and analyse a simple business plan in the next section. Before that, the following activity may be carried out

Self-Assessment Activity 1

Imagine any simplest business idea, and reflect as to from where you can get the following information. Jot down your response in the space given under each item.

- Identified product, range, scale and applications (uses).
- The process of manufacturing/servicing.
- Market information – customers, demand (volume and quality), competitors and price.
- Statutory requirements.
- Likely cost of all the project components.
- The breakeven point.
- Financial projections for a year.

The above Self assessment activity will help you to assess the technical-marketing-financial viability of your business idea.

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8.4 MUSTAFA – THE POTENTIAL ENTREPRENEUR

In this section, we shall present a hypothetical case study on a potential entrepreneur – Mustafa – and his business plan

Mustafa was 16 years old when he came from a far away village to Delhi to try his luck. After strolling on the railway platform and a few narrow lanes in the city, he got attracted to the idea of being a tailor. Mustafa's mother used to stitch clothes at home and he often helped her in arranging the materials, repairing the machine as well as putting some simple sewing. Mustafa joined the tailor as an assistant and learned the trade. Here, apart from stitching, other trades like cutting, needlework, and embroidery attracted his attention. He achieved perfection at cutting, stitching, finishing etc. very soon. The tailor got an order to stitch 1000 sets of school uniforms and entrusted the job under the supervision of Mustafa. The order was completed in time month and thereafter they had a regular market of bulk orders. Mustafa became the favourite of the tailoring house and was entrusted with maintenance of stores and accounts too. His hard work brought him rewards and his salary was increased to Rs.5,000 per month. After 3 years, today he has a bank balance of Rs.40,000.

His mother wants him to come back to his native place Arrah (Bihar), and start a garment manufacturing unit. Mustafa agreed to this, and, is a preparation, made certain assumptions and calculation, which are explained here.

The manufacturing unit will be located at Arrah in rented premises, and will manufacture "Kurtaas" (long skirts) for gents. The raw material shall be purchased from Patna (the nearly state capital) at weekly intervals and the Kurtaas will also be supplied to the retailers at Patna, on the basis of fortnightly payment. Mustafa intends to purchase two machines fitted with electric motors, various tools and some furniture like working tables, almirah for stock of materials etc.

He intends to manufacture 600 pieces in a month and for the purpose two workers will be employed at a monthly salary of Rs.2,500 each. The cost of materials for each Kurtaa has been calculated at Rs.50 and the anticipated sales price is Rs.80 a piece.

The projections of expenses and income made by Mustafa are given in Indian rupees as follows.

Article I.

Article II. Fixed Assets

Cost of two stitching machines	-	Rs. 6,000
Cost of furniture items	-	Rs.3,000
Cost of hand tools	-	Rs. 1,000
Article III.		
Article IV. Working Capital (per month)		
Cloth and other raw materials	-	Rs. 20,000
Rent	-	Rs. 2,000
Salaries	-	Rs. 5,000
Other miscellaneous expenses	-	Rs. 3.000
TOTAL	**-**	**Rs.40,000**
Income from sale of 600 kurtaas in a month	-	Rs.48,000
Cost of materials for 600 kurtaas	-	Rs.30,000
Salaries, rent and other expenses	-	Rs.10,000
Article V. Net Profit per month	**-**	**Rs. 8,000**

This profit of Rs. 8000 a month is more than what Mustafa was getting as salary. So he is happy with these projections. However, as counsellors to the potential entrepreneur, you may like to find if everything is right with this planning. In the subsequent sections we will discuss a few concepts and anaylse whether our client Mustafa had taken enough care to prepare his business plan.

8.5 WORKING CAPITAL AND PROJECT COST ASSESSMENT

Once you set-up any business venture and organise space, machinery, equipment, furniture, other fixed assets etc., it is time to start production/operations. What is needed before production is the finance to meet various operating expenses. We need to buy raw materials, consumables, spend on salary and wages, pay for rent, premium and for other services. Money needs to be spent for all these purposes. Therefore, finance is said to be the lifeblood of enterprise. All these expenses go on till the products or services are sold and proceeds are realised. The money to be spent till that time is known as *working capital.* To calculate the appropriate amount of working capital required and its arrangement is quite crucial for the success of business venture. For the purpose we need to understand the concept of *operating cycle.* This includes three stages.

i) **Stocking :** One needs to buy and maintain the stock of raw materials for a certain minimum period. This will depend upon various factors like nearness of the market, cost of procurement, availability of the raw materials and their shelf life. The stocking period might vary from a day to even 5-6 months.

ii) **Production** It will also take sometime to convert the raw material into finished products. This will depend upon the process involved and the timely availability of all the needed resources.

iii) **Sales Realisation:** Once the product is ready it has to reach the buyers, and, in return, the sale proceeds are to be collected. This also takes some time depending upon the demand and terms of the sale.

The time taken for all the three stages listed above, i.e. the stocking period, production time and sales realisation time put together constitutes an operating cycle of the business. The working capital is the total funds required to meet all the expenses of one operating cycle.

Let us help Mustafa in working out the length of his operating cycle.

Since the materials will be purchased once a week, the stocking period is	-	7 days
The production time for one marketable lot (For weekly supplies)	-	7 days
Sales and realisation time (credit to retailers for 15 days)	-	15 days
Total number of days in one operating cycle for Mustafa	**-**	**29 days**

So Mustafa needs to arrange working capital for almost one month to pay for all the expenses of this period. In other words, he needs to have enough money for:

Cost of raw materials for one month's production	-	Rs. 30,000
All overheads i.e. rent, salaries & other miscellaneous expenses for 1 month	-	Rs. 10,000
Working capital required by Mustafa	**-**	**Rs. 40,000**

If Mustafa goes ahead with only Rs. 30,000 as working capital (i.e. available funds), he might not be able to produce the targeted 600 Kurtaas per month. At the end of the third week, no raw material will be left for production and the unit shall have to wait without any production, till the sale proceeds arrive. During this period of idle capacity he will still have to bear all the fixed costs, like rent, electricity bill and wages of the employees. So, Mustafa has to arrange an additional working capital of Rs. 10,000 either as a loan from an institution or get a credit on purchase of raw materials.

Let us, therefore, note that the *operating cycle* is the sum total of the:

- time for which ready stock of raw materials is to be maintained;
- time taken for producing one marketable lot of the product(s); and
- time taken for selling and collecting the proceeds of one marketable lot.

And, *working capital* is the sum total of all operating expenses for the period of one operating cycle.

Project Cost

The total project cost will include:

- fixed capital for all the fixed assets and pre-operating expenses;
- working capital for one operating cycle; and
- contingencies (usually 5 - 10% of all expenses).

An entrepreneur should plan that the total project cost is somehow arranged from various sources before starting the business venture. The sources can be:

- Own capital
- Borrowings from relatives/friends
- Loans from banks/institutions
- Grants/subsidies if available
- Credit from the suppliers

In case of Mustafa, our potential entrepreneur, the *total project cost* will be:

Fixed capital	-	Rs. 10,000
Working capital	-	Rs. 40,000

8.6 APPRAISING THE BUSINESS PLAN

Preparing the business plan involves lot of effort in collecting information on the product, the process, the market, costs, prices and other financial variables. All this has to be done by the entrepreneur before the business plan is prepared. The data collected by the entrepreneur needs to be realistic. Also it should account for the anticipated or suspected variations in the sensitive inputs like market demand, cost of inputs, behaviour of competitors, market prices, government policies, unforeseen interruptions, etc. The appraisal part of the business plan revolves around all these critical issues and is covered under the following six heads.

8.6.1 Technical Appraisal

The entrepreneur should ask himself as to whether he has understood the process and technology involved in finer details. The technology should confirm to the availability of infrastructure, working environment and all the available inputs. It must be cost effective so that the ultimate product is priced reasonably. The enterprise has to arrange the trained manpower as per the requirement of selected technology and that too at the desired wage level. Based on all these a plan of production has to be prepared for a certain period. It must state the likely scale of capacity utilisation.

Anybody who appraises the project technically will have to check all the points listed above. If the entrepreneur has understood all the relevant points and has realistically planned the production/other operations, the conclusion can be drawn about the *technical feasibility* of the project.

The questions to be asked by each entrepreneur may be listed as follows:

- Whether the chosen technology is the most appropriate one; if it has been already tested commercially; it should not have become obsolete.
- Whether the entrepreneur has understood the total process and its critical inputs.
- Whether the necessary infrastructure and linkages are available to adopt/adapt the technology.

- The cost of the chosen technology vis-à-vis its benefits should be comparable with the other available processes.
- Whether our installed capacity will be matched by the technology/process selected.
- Whether the manpower planned is skilled as well as adequate according to the presumed capacity level and at the same time it will not remain idle.
- Whether the product/project chosen is confirming to the laws of the land.
- In case of need do we have the consultancy/servicing facilities available nearby.
- The raw materials, consumables and critical components as per the requirements of technology and hardware are readily available.

In case of Mustafa, he has to find answers to all these questions. If the answers to these are satisfactory, we can safely presume that the project is technically feasible.

Self Assessment Activity 2

Calculate the operating cycle and working capital requirement for Chitra's business of bangle selling, based on the following:

- She makes weekly purchases from Firozabad for an average of Rs. 5,000.
- The weekly sales are again Rs. 7,000 and no credit is given.
- Chitra pays the rent of the shop and salary of an assistant (total Rs. 3,000) at the end of each month.

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8.6.2 Marketing Appraisal

You would have often noticed that having set up an enterprise, a lot of small entrepreneurs flounder, because they have not been able to get an adequate market or generate enough sales to keep them earning. It quite often happens that small entrepreneurs start their businesses without taking into account the likely customer base. If at all they think of the customer, they do not consider the requirements or choice of the target group. It is for the entrepreneurs to understand from the beginning itself that the process of marketing starts as early as they get a business idea. In fact the starting point of a business opportunity should be in terms of the customer needs that thus business would fulfil. The entrepreneurs should observe the market in terms of demand and supply, study the strengths and weaknesses of present suppliers (competitors), understand the system of sales and based on all these should device a marketing strategy. They should infer as to what and how much should be produced/arranged and what should be the channels for its sale.

At the same time sticking to one market and only a single product might be risky. The entrepreneur must keep on trying for diverse markets, customers, products and channels.

So, the following questions should be addressed in case of marketing appraisal of any business idea

- Who can be the customers or users of my product/service?
- What and how much exactly is required by each of these potential customers. Which features they value most?
- What is the price they can afford to pay?
- Who are my present competitors and what are their strengths/ weaknesses?
- What is the likely future scenario of demand and supply of the chosen project?
- How the sales are made and what are the norms for collecting the proceeds?
- What selling channels shall be adopted to push the products?
- If there is any USP (Unique Selling Proposition) in my product?
- How do I manage to get the market feedback while selling the existing products?

Satisfactory answers to all these questions will suggest the marketing aspects of the project.

8.6.3 Financial Appraisal

The basic aim of financial appraisal is to assess whether the project will bring profits. To work out this, one needs to have a look at the projections for income and expenses for a period of 3-5 years. The projections may include all possible expenses on various inputs. Here the cost of fixed assets, installation expenses, pre-operative costs, all the components of working capital along with financial and selling expenses need to be included.

Similarly, the income from all the sources has to be projected for given periods. The excess of the income over the expenses shows the likely profit. Out of this gross profit the entrepreneur has to deduct the financial costs, viz. interest on the capital employed and the depreciation on the fixed assets. The end result is net profit. In case this is positive we can assume that the project is financially viable.

When we refer to the profitability projections of Mustafa as given in section 4.5, the project looks viable. However, it does not carry the following costs:

- Interest on the total funds, i.e. the opportunity cost of money.
- Depreciation on the fixed assets.
- Subsistence salary of the entrepreneur.

Moreover, the projections have been worked out at cent percent of sales/capacity utilisation and that too for a month. Let us be clear that in most of the businesses the actual capacity utilisation or sales can never be up to the installed levels. Usually, for the new enterprises, the capacity use in initial periods may revolve around 50-60 percent. It may gradually increase with the experience and conduct of business. It is therefore reasonable to plan at the level of 60-70 percent of capacity utilisation.
Similar situations may be observed when your clients prepare the projections in their business plans. You need to suggest them to revise the projections by including all probable expenses, and also plan at realistic levels of capacity utilisation. Also, they may be asked to prepare the projections for a longer period, preferably for next 3-5 years.

8.6.4 Sensitivity Analysis

The projections made in the business plan are based on certain assumptions. These may be related to the costs of raw materials, prices of the products, market demand, estimated production level, availability of key inputs etc. Some of these assumptions may not come true. In that event our entire plan is likely to be in jeopardy. To avoid that situation, we take an estimation of the likely scenario for different estimations.

Checking as to how a slight change in any of these critical parameters might affect the profitability is known as 'sensitivity analysis'. Entrepreneurs should try to find out the critical factors in the venture selected. These can be the inputs whose availability or price level is likely to change over a period of time. Similarly, variations in the price of the product may also be assumed for such an analysis. The profitability projections need to be worked out again with the revised costs level of the critical inputs. This reflects the sensitivity of the business to any critical changes.

In the case of Mustafa's business, if the cost of materials on each Kurtaa goes up by Rs.10 or the sale price per unit comes down by Rs10 the assumed profit of Rs.8,000 will come down by 75 percent. Considering another critical factor if the demand and thereby the production, remains at 50 percent of the anticipated levels, the business will incur an immediate loss.

8.6.5 Break Even Point

In any business the costs can be categorised into two types.

i) A few costs are fixed in the sense that they remain unchanged with increase or decrease in production. The rent of the premises, salaries of staff, financial costs like interest, depreciation on fixed assets, insurance premium, certain taxes etc. are examples of fixed costs that remain fixed irrespective of the level of actual production.

ii) The second set, called the variable costs, varies according to the level of production. These include the cost of raw materials, consumables, wages, consumption charges for electricity, water, fuel, etc.

The fixed costs would be incurred for day-to-day operations even if the actual production is too less or even nil. The variable costs increase or decrease with the level of production. When it comes to calculating the total cost, up to a certain level of activity the total costs (fixed + variable) are much more than the revenue generated. Gradually with the increase in activity, a point comes where the total costs become equal to the revenue generated. This point is known as ***Break Even Point* (BEP).** This is the point of operation at which the business has no profit or no loss.

For every enterprise the BEP needs to be calculated. For this purpose the entrepreneur has to categorise all costs into fixed or variable. Your client must recognise that the capital goods or fixed assets acquired by him/her like machinery or building undergo wear and tear. This is called *depreciation*. The depreciation on fixed assets has to be taken into account as one of the fixed costs. Similarly, the variable cost incurred in producing and selling one unit of production has to be worked out.

To calculate the Break Even Point, the following formula can be applied.

$$\text{Break Even Point} = \frac{\text{Total Fixed Costs}}{\text{Unit Sale Price} - \text{Unit Variable Cost}}$$

Let us try to find out the BEP for our friend Mustafa.

Various fixed costs per month in his business are:

Rent	-	Rs. 2,000
Salaries	-	Rs. 5,000
Miscellaneous Overheads	-	Rs. 3,000
Total Fixed Costs	-	**Rs. 10,000**
Unit Sale Price	-	Rs. 80
Unit Variable Cost	-	Rs. 50

$$\text{Break Even Point} = \frac{10{,}000}{80-50} = 333 \text{ Kurtaas}$$

Mustafa needs to produce 333 Kurtaas per month for which the total cost incurred will equal to the total revenue generated. The enterprise will start making any profits beyond this point, and if the production and sales remain below this level there will be losses. For the entrepreneurs, it is important to assess as to whether they can operate at least above the Break Even Point or how fast they can cross this level. Any business with a high BEP is a risky proposition for the small entrepreneurs. Similarly, the lower BEP denotes lesser risks.

8.6.6 Debt Service Coverage Ratio

Whenever a loan is taken for running the business it has to be serviced by timely payment of interest and principle. To find out the scope of debt servicing, the following calculations are made based upon the profitability projections given in the business plan.

$$\text{Debt Service Coverage Ratio(DSCR)} = \frac{\text{Net profit + Interest + Depreciation}}{\text{Interest + Instalment of Loan}}$$

The net profit + Interest + Depreciation is in fact the surplus available with the entrepreneur out of which the loan instalment and interest has to be repaid. A fair DSCR should be 2 or more so that at least 50% of the surplus is still available with the entrepreneur even after repaying the loan commitments.

Self-Assessment Activity 3

Suman started her business of soft toys and arrange the raw materials from Delhi, which is 160 kms from her town. She purchased the wool, cloth, fur and other accessories worth Rs. 9,000 from Delhi and paid Rs. 1,000 as freight charges. Two workers who get Rs. 5 on each piece prepared by them are assisting her. Suman could prepare 200 teddy bears out of this material in a month and sold it at Delhi for Rs. 15,000. Once again she incurred the freight charges of Rs. 1,000.

After these sales Suman has to pay the following bills:

Rent	-	Rs. 1,500
Electricity	-	Rs. 200
Salary – Assistant	-	Rs. 1,000
Bill for packing material	-	Rs. 1,000

Find out the fixed and variable costs in her business and also calculate the breakeven point.

What will be the DSCR if Suman avails a bank loan of Rs. 30,000, with all the above assumptions of costs and prices (Note: there are no fixed assets)?

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Check Your Progress A

1 What do you mean by Project Report ?

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2 List out the expenses which go on till the products/services are sold and proceeds are related

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3 What the points to be checked to appraise the project technically ?

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4 What is Break Even Point ?

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5 How to find out the scope of debt servicing ?

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6 State whether the following statements are **True or False.**

a) Scanning of analyzing the environment might not bring out several business opportunities to choose from. True ☐ False ☐

b) The simplest and smallest business venture also needs meticulous planning.

True ☐ False ☐

c) The aim of the question "will you product sell? How is to know the strategy.

True ☐ False ☐

d) Production is the first stage of operating cycle.

True ☐ False ☐

e) The information collected by the entrepreneur needs to be realistic.

True ☐ False ☐

f) The cost the chosen technology and is benefits should be comparable with the other available processes. True ☐ False ☐

g) The process of marketing do not starts as early as entrepreneur gets a business idea. True ☐ False ☐

h) The capacity of utilisation may gradually increase with the experience and conduct of business. True ☐ False ☐

i) The point where the total variable costs equal to the revenue generated is known as BEP. True ☐ False ☐

8.7 THE FORMAL CREDIT SYSTEM

In India, till about three decades ago the banks were not considering any loans to micro enterprises especially those being started by the first generation entrepreneurs. With the adoption of priority sector lending and especially social banking, the scenario changed, and the Reserve Bank of India (RBI) instructed the nationalised and other banks to extend at least 10 percent of their total credit to weaker sections of the society. This was meant for the poor people who could not confirm to the normal requirements asked by the banks. To help achieve these targets the central and state governments have also launched several welfare programmes. These schemes of lending are supported by the respective governments through subsidies or soft loans in the form of margin money. For the small entrepreneurs these schemes can be helpful to make a beginning. But before discussing any of these schemes it is necessary to understand the pre-requisites or norms of lending by the banks.

Legal status

Any citizen of the country who has attained 18 years of age, is of sound mind and has not been barred by the court to contract can avail a loan from the bank.

Identity of the person

Whenever one needs to open a bank account, the identity has to be proved by the applicant. To avoid any kind of impersonation and also to be sure about the address of the account holders, banks do need the proof of residence. This is so if a deposit account is to be opened. When it comes to avail a bank loan, usually the banks insist upon the applicant being a permanent resident of their operational area. So, before dealing with the bank in any capacity one should have a proof of identity and the address.

Knowledge of the project/activity

Any prudent entrepreneur would acquire all the details of selected activity/project before it is launched. The groundwork in the form of a market survey, information regarding technology, process involved, the markets all these have to be understood by the entrepreneur. All this should be reflected in the project report or the business plan prepared. The banking system does need a business plan prepared, fully understood and owned by the perspective borrower. This business plan helps them understand the viability of the proposal and analyse whether their funds can be wisely invested on the project.

Stake of the borrower

The banks insist that in any project , there must be some investment by the entrepreneur. Towards this purpose the perspective borrower is supposed to:

- contribute some margin money (5-25% of the project cost);
- offer some tangible security (100-200% of the loan amount).

However, for the micro enterprises these norms have been relaxed to some extent. Especially under government-sponsored programmes, the banks have been advised not to insist on any margin money or collateral security. These norms are still insisted upon to find out the commitment of the borrower and ensure safety of banker's funds.

Trust of the bank

The foremost and the most important pre-requisite for any borrower is to win the trust of the banker in person and also in the business undertaken. The banks are dealing with public money and do owe full responsibility of managing it profitably. Thus, slightest laxity on their part might expose the system to risks. So, before lending to anybody they want to be sure about the person and viability of the project.

To ensure a relatively smoother loan from the bank the entrepreneur must maintain a regular relationship with the bank. In addition to the bank account a prospective borrower should somehow keep the concerned bank officials aware of the business activities or the plans. A closer and healthier relationship always helps in winning the trust of a person.

Also the knowledge and ability to handle one's own project gives the entrepreneur a convincing edge to approach the bank. Once a banker is convinced about the person, the project and the repaying capacity, he/she will be too eager to lend the money. Otherwise an unconvinced banker may never agree to any loan proposal and might avoid lending under one or the other pretext.

So the entrepreneurs should maintain a regular touch with their bank and in case of likely need must keep their bank informed about the business activity.

8.8 THE GOVERNMENT SPONSORED SCHEMES

Several schemes of bank lending formulated by various state agencies in India and approved by the Reserve Bank of India are in operation. Each of these schemes is for a specific category of people. A few of these categories include the following:

- Rural Poor
- Urban Poor
- Unemployed Youth
- Rural Enterprises Generating Employment
- Poor from Scheduled Castes/Tribes
- Women Entrepreneurs
- Entrepreneurs belonging to Religious Minorities
- Entrepreneurs belonging to Other Backward Classes

A brief account of some of these schemes is given in the following table that explains the eligibility criteria and the nodal agency for each. This may help you identify some schemes for the benefit of your clients.

Government Sponsored Schemes – Salient Features

Category	Scheme	Eligibility	Benefits	Nodal agency
Rural Poor	Swarna Jayanti Gram Swarojgar Yojana (SGSY)	Identified rural poor	Loans with subsidy No collateral security for individual loans of Rs.50,000 and group loans of Rs.0.3 million	DRDA and Block Dev. Officer
Urban Poor	Swarna Jayanti Shahari Swarojgar Yojana (SJSRY)	Poor urban residents for the past 3 years	Loans with subsidy No collateral security for individual loans of Rs.50,000 and group loans of Rs.0.3 million	DUDA and Municipality of the town/ city
Educated Unemployed Youth	Pradhan Mantri Rojgar Yojana (PMRY)	Educated (min.10th) youth(18-35 yrs. age) and with annual family income <Rs.40,000	Individual loans for projects of 0.2 million and Group loans for projects up to 1 million Subsidy No collateral security for projects of Rs.0.1 million	District Industries Centre or SISI
Rural Enterprises	Rural Employment Guarantee Programme (REGP)	Entrepreneurs setting up industrial units in rural areas	Loans for Individual projects upto 1 million and groups upto 2.5 million lacs Margin money/subsidy of 25% of project cost	KVIC or KVIB
Poor from Scheduled Castes/Tribes	Special Component Plan (SCP)	SC/ST people living below poverty line	Loans for the projects Subsidy Margin money loan at concessional interest	SCFDC
Women Entrepreneurs	Margin Money Scheme (MMS)	Women entrepre-neurs	Loans for the projects Margin money loan at concessional interest	WDC
Entrepreneurs belonging to Religious Minorities	Margin Money Scheme (MMS)	Entrepre-neurs belonging to religious minorities	Loans for the projects Margin money loan at concessional interest	MFDC
Entrepreneurs belonging to OBCs	Margin Money Scheme (MMS)	Entrepre-neurs belonging to OBCs	Loans for the projects Margin money loan at concessional interest	BCFDC

You should remember to tell your clients that in order to avail the benefits under any of these schemes the usual pre-requisites of bank lending, like identity of the person, a convincing business plan and personal stake are to be met by the borrowers.

8.9 ALTERNATIVE CREDIT DELIVERY SYSTEM - SHGS

For the migrant people, who move from rural areas to urban in the search of opportunities, it is difficult to prove their resident status in the initial stages. Until they stay at one place for quite sometime and maintain relationship with the bank, they may not be in a position to convince the bankers for a loan.

This is more so for the street children, who are in the formative years of their life. For them to avail a bank loan, the requirements shall be:

- Proof of age for being major.
- Identity and proof of residence.
- Past dealings with the bank.
- A business plan.
- Guarantee or collateral security.

Even after all this, they may not find a co-operating banker to help them out. This is the case with many people from deprived groups. However such people have proved themselves through the vehicle of *Self Help Groups* (SHG).

In SHG, the willing people join in an informal group and pool their resources by way of thrift. These pooled resources can be lent to the needy members of the group on the terms to be decided by consensus. The periodic (usually monthly) savings by all the members are maintained in a bank account and the operations for lending and recovery may also be carried through the bank. The SHG maintains the records for all its meetings and accounts just like a small bank of their own. They do keep in touch with their bank and invite the officials to witness their activities from time to time. The process earns them the confidence of the bankers and after a while (usually 6 months) they are able to avail a common loan from the bank. This loan is for onward lending to the SHG members and the responsibility of its repayment lies with the entire group. *However, to avail any loan from the bank all the members of SHG should be major, i.e. of more than 18 years of age.* The experience of bankers in lending to SHGs is quite encouraging. The process has shown good results in many parts of the country and banks are accepting such groups for lending.

Another mode of lending to the SHGs is through NGOs. Here again the organisations with proven track record can avail credit from several sources like SIDBI, RMK, NMFDC and Commercial Banks. These NGOs get the credit line for onward lending to the SHGs. Perhaps in the days to come the Self Help Groups phenomenon will pick up fast and might emerge as a strong alternative credit delivery system

8.10 MAINTENANCE OF RECORDS AND ACCOUNTS

Properly maintained records help the entrepreneur to keep track of the health of the business. In the absence of these the financial management of any kind may not be feasible. These records help the entrepreneur to:

- monitor the cash flow
- record all the expenses to find out the costs involved
- check pilferages due to loss of memory, theft etc.
- keep track of the debtors and the creditors.
- find out the profitability.
- prepare the accounts as per statutory requirements.

You must explain to your clients the need for maintaining proper records of business. It is easier for them to have a general idea of their cash income and expenditure. Often they lose sight of their dues or what others owe to them. Unless they make it a habit of recording every transaction in money terms, they may lose sight of important business details.

How to maintain the accounts

The business records are always maintained in terms of money or materials. The basic recording is of three events.

- What comes in – The Receipts
- What goes out – The Payments
- What remains – The Balance

The accounts are written in terms of either debit or credit. For every transaction there are two complementary entries in two or more accounts. The account that receives a benefit is debited and the account that gives out a benefit is credited. You may be able to help your clients with a little practice on writing the accounts.

Books of accounts

The books that need to be maintained by the entrepreneurs are:

- Cash book
- Purchase book
- Sales book
- Ledger
- Stock register

By maintaining these basic records your clients will be in a position to monitor the health of their business.

Cash book entries

Here all the cash transactions of a day are recorded. A specimen of cashbook with a few transactions recorded is given below.

On August 10, 2002 Raman Swamy withdrew Rs. 5,000 from the bank and made sales for Rs. 670 in cash. He purchased fresh stock for Rs.1,700 and paid Rs. 785 towards telephone bill.

Again on August 11, he paid the municipal tax amounting to Rs. 1,000 and recovered Rs. 5,200 from Mathura Das, an old client. This is recorded as follows.

Dr.	Receipts		Cash Book		Payments		Cr.
Date	Particulars	L.F	Amount	Date	Particulars	L.F	Amount
10.8	To Bank		5,000	10.8	By Stock Purchase		1,700
	To sales		670		By telephone bill		785
	Day's Total		5,670				2,485
					Closing Cash		3,185
11.8	To Opening Cash		3,185	11.8	By Municipal. Tax		1,000
	To Mathura das		5,200		Day's Total		1,000
	Day's Total		8,385		Closing Cash		7,385

Note: L.F. notes the ledger folio no., on which the corresponding entry is made subsequently.

When an entrepreneur is operating a bank account and the business transactions are through that account too, a cashbook with two separate columns for cash and bank under the head of amount is used.

Here the money deposited with or withdrawn from the bank is recorded in bank and cash columns both. If Mustafa withdraws Rs. 4,000 on August 14 from the bank for business, following entries shall be made.

Dr.	Receipts		Cash Book			Payments			Cr.
Date	Particulars	L F	Cash	Bank	Date	Particulars	L F	Cash	Bank
14.08	To Bank		4000		14.08	By Cash			4000

If a transaction involves either cash or cheque, it will be entered in the respective column. Any payment or receipt through cheque (after depositing in bank) shall be recorded in the bank column.

Let us be very clear that no credit transactions (i.e. purchases or sales) shall be recorded in the cashbook.

Purchase and Sales book

For the transactions done on credit terms the entries are made either in purchase book or in sales book. Here the entries are made in respect of the business goods only and not in respect of any fixed assets purchased or sold. So, the purchase or sale of machineries, furniture, vehicle, etc. shall not be entered in purchase or sales book. A sample of these books is shown below.

Date	Particulars	Invoice No.	L.F.	Details (Amount)	Total Amount

In the particulars column, the details of goods purchased or sold, their specifications, rates, discount if any, freight etc. are recorded.

Ledger

All business transactions in the classified form are recorded in ledger. There can be several types of expenses or incomes in a business. So according to the need and perception of individual business the transactions are classified into several accounts and ledger of each of these accounts are maintained on separate folios.

Give below the proforma of the ledger.

Dr. **Name of Account** **Cr.**

Dr.	Name of Account						Cr.
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount

The entries in the ledger are made from cashbook or other subsidiary books like sales book, purchase books, etc. The transactions related to separate accounts should be entered separately and care should be observed to avoid any mistakes. This is necessary for the reason that each separate account reflects a particular aspect of the business and its pattern carries a different meaning for the financial management.

These accounts are reconciled periodically and consolidated in the form of a balance sheet, which is reflection of the health of any business. It is on the basis of these accounts and the balance sheet that an entrepreneur can make inferences and initiate necessary steps to improve the efficiency of operations.

Check Your Progress B

1 What aspects are to be reflected in the project report for getting bank loan for small business ?

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2 Why the borrow win the trust of the banker ?

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3 List out the various schemes of bank lending.

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4 What is the concept of self help group ?

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5 What are the benefits of maintenance of records and accounts ?

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6) State whether the following statements are **True or False**.

a) With the adoption the banks to be provide loans to weaker sections.
True ☐ False ☐

b) Any citizen of the country can avail a loan from the bank True ☐ False ☐

c) An unconvinced banker may never agree to sanction any loan proposal.
True ☐ False ☐

d) IN SHG, the willing people join in an informal groups and post their resources by way of thrift. True ☐ False ☐

e) Cash bank is meant to record all transaction of the enterprise.
True ☐ False ☐

f) All business transaction in a classified form are recorded in ledger.
True ☐ False ☐

8.11 LET US SUM UP

To sum up what we discussed in this Unit:

- Before starting a business one must think, observe, analyse and prepare a business plan.
- The entrepreneur him/herself is the best person to plan the activities in detail.
- Preparing the business plan means seeking answers to the situations that are likely to arise in the course of business.
- Working capital is a crucial element in the business activity and it depends upon the duration of operating cycle in the business.
- Appraising the plan means finding out the probability of business idea to be practical, the product to be marketable and the likely return in terms of cash profit.
- Arrangement of funds depends upon the norms of lending by various agencies and we can avail the benefit under some of the government-sponsored programmes available.
- To know the health of the business and in order to keep track of goings on, we very much need to maintain the books of accounts and some records.

It does take some effort to plan, appraise and monitor the business, but ultimately it pays in terms of lesser mistakes and better profits.

8.12 KEY WORDS

Accounts: A narrative or records of events. The accounts are written in term of either debit or credit

Bank: A bank whose principal function are to receive demand deposits and to make short-term loans.

Break even Point: Point of operation at which the business have no profit or no loss. Gradually with the increase in activity a point comes where the total costs become equal to the revenue generated.

Cash Book: A book in which a record of cash receipts and expenditure is kept

Ledger : All business transaction in the classified form are recorded in a ledger. A ledger is a book in which the monetary transaction of a business are posted in the form of debits & credits.

Working Capital : Working Capital is defined as the difference between assets and liabilities. Working capital measures how much in liquid assets a company has available to build its business.

8.13 ANSWERS TO CHECK YOUR PROGRESS

A	6	a)	False	b)	True	c)	True	d)	False
		e)	True	f)	True	g)	False	h)	True
		i)	False						
B	6	a)	True	b	False	c)	True	d)	False
		e)	True	f)	False				

8.14 TERMINAL QUESTIONS

1) What is Business Plan ? What factors are to be considered while preparing it ?
2) What are the key questions you would like to ask your client which help to prepare the plan ?
3) Illustrate a hypothetical case study on a potential entrepreneur and his/her business plan, on your own, to motivate your client.
4) What is working capital ? Explain the different stages of operating cycle and help Mustafa, a potential entrepreneur, in working out the operating cycle for his venture.
5) Discuss the major issues of appraising the business plan.
6) What are the questions one should answer properly in case of marketing appraisal of any business idea?
7) How would you calculate the BEP ? Explain it with an example.
8) Distinguish between financial appraisal and Marketing appraisal.
9) Distinguish between Debt Service Coverage ratio and Break Even Point.
10) Explain the pre-requisites/norms of lending by the banks to small entrepreneurs.
11) Describe the salient features of various government sponsored schemes to start a small enterprise.
12) How would you explain to you client about the need for maintaining proper records and the procedure to maintain the accounts of small business?
13) Write short notes on the following :
    a) Significance of Business plan
    b) Operating cycle
    c) Marketing appraisal
    d) Break-even point
    e) Alternative credit delivery system

Note : These questions/exercises will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the university for assessment. These are for your practice only.