

SECTION II: Running a business

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RUNNING A BUSINESS

Having identified and started a business is, by itself, not enough to ensure its success. Running it efficiently is essential to ensure that the business stays competitive and profitable.

This section covers topics relevant to the day-to-day management of the business, like:

- Understanding needs and wants of customers (communicating with the customer).
- Production/Manufacturing.
- Buying and stocking.
- Pricing the product/service.
- Accounting and managing day-to-day finances.

To be a successful consultant it is essential to understand the concepts and principles covered in this section and to develop the skill to apply them in diverse practical situations which may arise in the field.

Let us now take a look at these concepts and principles in detail.

Marketing

6

What are we going to look at in this chapter?

- Understand the needs and wants of people.
- How marketing is the process of providing the goods/ services to meet those needs/wants.
- The process of exchange involved in satisfying needs and wants identified.
- Understanding the consumer communication and its importance in the process of exchange.
- The actual process of marketing.

What is 'marketing'?

Marketing may be defined as satisfying the **needs of** consumers, by a business enterprise, by providing them the goods and services they require in exchange for money. This involves understanding your customer/buyer and promoting your product.

What are 'needs'? And how are needs satisfied?

Needs are very basic,
like:

Objects/services which satisfy
these needs

Shelter



House to take shelter in

Needs are very basic.
like:

Objects/services which satisfy
these needs

Food



To satisfy hunger

Water



To quench thirst

Education



To achieve literacy and
numeracy

What are 'wants'? How do they differ from 'needs'?

A want is something a person desires, whether it is needed or not. It is more than a need. But 'need' can also be qualified with 'wants'.

Shelter



You may want a house which gives status/meets specific requirement.

A big house/A house with land for children to play.

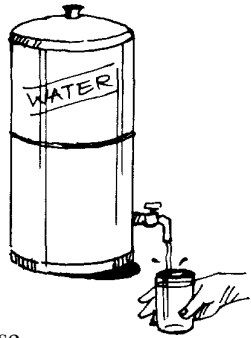


Food with nutritional value, like *dal*, rice, milk, egg, vegetables,

Tasty - Sweets, snacks

Convenient - When there is no time to make it

Water



Clean water to prevent disease

Education



Self-development to become something in life.

How is a need met?

A basic need may be satisfied by:

Self-production



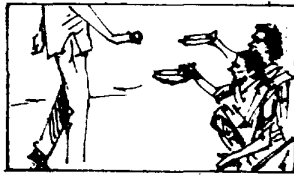
Cooking to meet hunger need.

Coercion



Grabbing from someone else.

Supplication



egging from someone else

Exchange



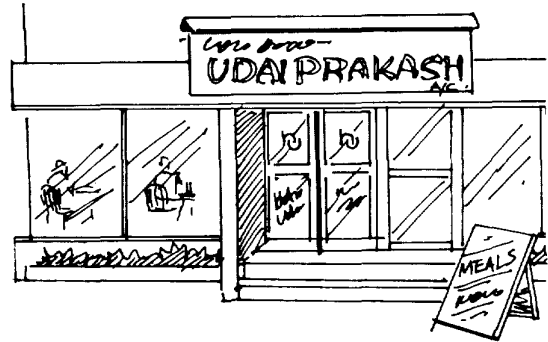
Exchanging some other resource for food. The resource may be money, other goods or services.

Society basically centres on the process of **exchange**.

Let us now look a little more closely at wants, needs and the process of exchange.

How does the process of exchange occur?

The individual knows his needs and wants as well as what he can give in exchange for them. *i.e.* **MONEY**.



Both the stalls are food stalls, but they satisfy different needs.

The decision to eat at one or the other would depend on a number of questions.

What time is it?

Early morning or evening or midday.

Why are you going there?

To while away your time or have a quick bite to eat.

Where is it?

Near workplace, near house.

How much money can be spared?

Having decided on a product which is needed by the people and having made it, can you safely assume that the product will now sell? *Let us c'onsider the story of Das.*



Das is veiy good with his hands. He likes making new implements.



Das lives in a village near Manakudy. There is a major problem of rats in his village and in the neighbouring villages.



Das decides that the people of the village need an effective rat trap to solve their problem.

He put his mind to it and made the most superior rat trap. Thereafter he sat at home and waited for orders for the rat trap. He waited a long time and none came.

Guide discussion to include

Das was surprised. But, he shouldn't have been. How are people to know that he has got a solution to their problem? He has not marketed the product.

Marketing therefore assumes

- there are two parties;
- each has something of value to the other; and
- each is capable of communicating with the other.

How will Das show that his rat trap works?

To whom will he prove this? To elders in the community? Or a shop-keeper through whom he could sell the traps?

What are the features he should stress: quality, reliability, fair price?

There are, of course different ways of communication. They could be by word of mouth, by demonstrating to a group of people, by using printed material (signs, posters etc.). The method chosen should be the one which most effectively reaches the customer at low cost and is received positively. *E.g. the people of the village may not be willing to buy his rat trap for Rs.20/- if he were to put up a notice in the village to that effect. They have each bought rat traps earlier which have not worked.* Now what should Das do?

Process of marketing

Having looked at what marketing is and why we need to market a product, let us see how you should set about it.

Before actually marketing a product, you should understand:

Who the customer is.

What the customer is really looking for.

What you wish to communicate to the customer and how you could do it most effectively.

Who is the customer?

Though the local market is a place to begin with, you should look beyond to see where the real market for the product is. *e.g. the best market for products like seafood. is probably the nearest town and not the village.*

What is the market looking for?

- A need satisfied,
- as well as other qualities.

e.g. if FOOD is the need and people need a hot meal near their work place, they would also expect

- *a certain quality of food;*
- *probably hot food;*
- a clean location;*
- *cleanliness in preparation/serving;*
- *a reasonable price; and, perhaps.*
- the food packed for them.*

What are we going to communicate and how are we going to communicate to the market?

There should be effective communication of the needs met by your product/service.

What is effective? This means that the message must reach the right people and be believable to them.

Who are the right people?

- People likely to buy the product/service.
- People likely to influence the buying.

What makes the message believable?

- Realistic claim, feasible idea, no exaggeration.
- Product should live up to the claim.

EXERCISE

Given below are a list of microenterprises which could be started by fisherfolk.

The product/service is mentioned. Write down against each

- the primary need met by the product;
- the other needs that could be met;
- the expectations from the product/service;
- the likely buyers of the product/service; and
- the communication process: What should be the message? whom should it be addressed to, and how?

| <i>Products/ Services</i> | <i>Primary needs met</i> | <i>Expectations from product! service</i> | <i>Main buyers</i> | <i>Message to be communi- cated</i> | <i>Who and how to be ad- dressed</i> |
|-------------------------------|----------------------------------|---|------------------------|---|--|
|-------------------------------|----------------------------------|---|------------------------|---|--|

1. Fish processing
2. Fish culture
3. Net-making
4. Engine repairing
5. Teashop with snacks
6. Vegetable vending
7. Coconut cultivation
8. Cycle repair shop

The discussions should enable the participants to understand each other's thoughts and, thus, clarify their own on the concept of primary needs, expectations, the buyer, and the effectiveness of message communicated.

Discuss why the messages and media suggested should be used.

THINGS TO REMEMBER

- Marketing is directed at satisfying needs and wants through a process of exchange.
- ‘Needs’ are basic, like shelter, food etc. ‘Wants’ are satisfaction of basic needs, are also more defined and show the aspirations of people.
- The process of exchange occurs when the individual translates his needs and wants into buying what is available in the market, if he can afford it.
- The process, therefore, assumes that the two parties understand each other and are able to communicate with one another.
- The process of marketing involves:
 - Understanding your customers;
 - Knowing what the customers are looking for; and
 - Communicating to the customers, *i.e.* ensuring that the message is truthful and that it reaches them.

Production / Manufacturing

7

What are we going to look at in this chapter9

- What is meant by a production or manufacturing enterprise
- The different kinds of production processes.
- Selection of a specific process.
- What production management is all about

What kind of enterprise is each of the activities shown below?



Among the activities shown in the pictures, only fish paste-making is a production or manufacturing enterprise.

A production **enterprise** is one where the raw material (fish) is bought or collected, is then processed (value added) or cultivated, and the product made. In some cases, the product is then packed in the required quantities and transported to the selling points, the traders/customers. In the vegetable shop, vegetables are bought and sold as they are and, hence, there is no production involved. It is only a buying and selling (trading) enterprise. In the cycle repair shop, the person is waiting for cycles needing repair to arrive. He offers his services, his skills, to put them in order. Therefore, this is a service enterprise.

What is it that is exclusive to production/manufacturing enterprises?

In production/manufacturing enterprises, value is added to raw material and a finished (end) product made.

There could be several types of processes to make the end product.

e.g. shoe-making or hook-and-line fishing is a job process, as each shoe has to be made or each fish caught by a person.

Aquaculture and agriculture deal with periodic crops. So, *growing shrimp or pumpkins* is a batch process. *Shrimp paste processing* is also a batch process. The shrimp are marinated in batches *i.e.* each batch is left to ferment for a time every day. The batch size would depend on the size of the container (production capacity) or the demand for the product.

Illustration

Quantity of shrimp paste which can be sold = 15 kgs

Capacity of container = 20 kgs

Only 15 kgs of shrimp paste should be produced as more than that would not be sold.

On the other hand, if the capacity of the container were only 10 kgs. the quantity which is processed might only be 10 kgs.

Batch size, could, thus, be limited by the production capacity or the customer demand, whichever is lower.

Continuous process, on the other hand, is a process which does not come to a stop at all. If it does, the cost of restarting would be high. These processes may require complex equipment if they are in manufacturing, but carp ponds, tea estates and dairies are simpler forms of continuous production processes.

The process selected is usually determined by the product and the skills, money and equipment available. *E.g. take the case of shoe manufacture. This could be a job process, with a person making one pair of shoes completely before starting on the next. This could also be done as a batch process, with several shoes being manufactured at a time.*

Let us assume there are three different steps in manufacturing shoes:

- Stitching the upper;
- Making the sole; and
- Joining the two.

There is a demand for 10 pairs of shoes.

If three people get together and each does what he is best at in this manner,

NOTES

Shoe upper
10 pairs

Soles
10 pairs

'C'
Stitching
10 pairs of shoes

the shoes will be ready in batches of 10 pairs a day.

What is production management?

Production management ensures that your production process does **NOT** come to a stop.

The process could come to a stop because of many reasons:

- Equipment breakdown and no one, or no spares, to repair it.
- There is no raw material to work with.
- There is a production bottleneck *e.g. A' can make 10 pairs of shoe uppers and 'B' can make 10 pairs of shoe soles. But 'C' can only stitch 5 pairs of shoes in a day.* This would mean that 'A' and 'B' should also make only 5 pairs of uppers and 5 pairs of soles. The other way to overcome this production bottleneck would be to have one more person stitching, thus increasing the capacity to handle 10 pairs of shoes a day.

You need to study the process, see where the bottleneck is and work out ways to remove it.

Solutions could lie in re-allocating work, training for better skills, getting additional manpower, getting better equipment, stocking carefully on spares, arranging for routine maintenance or even ensuring regular supplies of raw materials.

You should not produce too much

The quantity produced should also be saleable. It would therefore be a good idea to restrict production to demand level, unless you can do something to increase demand for the product.

What you produce must be of relevance to the market

Modification to suit customer requirements should be a continuous process.

The product you currently make may have some defects. Such defects should be rectified and a modified version produced. Also remember that modification is a continuous process.

What you produce should be as effective/v a.c possible

Effective production can be had by optimizing the mix of land, labour and capital. This could be achieved by making changes in the working methods or by employing better tools, e.g. 'A' *could probably increase his production to 15 pairs of shoe uppers if he were to use better tools or implements.*

Raw material could be used more effectively, e.g. *if you are able to either use less of it or use a less expensive material without reducing the quality of the product.* This can be done with a bit of planning.

Finally, what you produce must be of a certain quality

Products should be made well: they should be of a certain quality to satisfy the customer. To ensure this quality is maintained, the products must be checked where they are made before they are sent out.

Check a certain number of units manufactured every day. The number could be fixed, say 5, or it could be a proportion, say 1 out of every 5 units. Obviously, the more you check the better the quality. However, the time and costs involved rule out a near 100% check and you will probably only check a representative sample of production. e.g. *if there are five hatches of production a day and you have decided to check 5 units for the day, you should ensure that you check one from each hatch.*

What do you do when there are defects?

Defects may arise due to faults in instructions given, machinery malfunction or mistakes made by people. The cause of the defect should first be identified and remedied so that the production of defectives can be stopped. Defective or flawed units could be rectified, if possible, and, if not reused, sold as 'seconds' at a discount. In the long run, it may be cheaper to work to avoid faults than to rectify or replace products after the faults are discovered.

THINGS TO REMEMBER

- Production is a means of adding value to raw materials and making a finished product.
- Different methods of production are:
 - Job process.
 - Batch process.
 - Continuous process.
- Selection of the method of production depends on
 - the product being manufactured, and
 - the resources available.
- Production management ensures
 - being able to produce the required amounts of products of acceptable quality in the required time, and
 - optimum utilization of resources available (land, raw material, labour, power, machinery, etc.) to reduce cost of production and improve quality of product.

Purchasing / Buying

8

What are we going to look at in this chapter?

- Where to buy.
- At what quality.
- At what price.
- How much to buy.
- When to buy.
- Advantages of collective buying.

What is 'purchasing'?

Purchasing raw materials or finished goods is an important function in a business as it affects the cost of goods produced or traded, the level of profit and customer satisfaction.

ACTIVITY

Group discussion

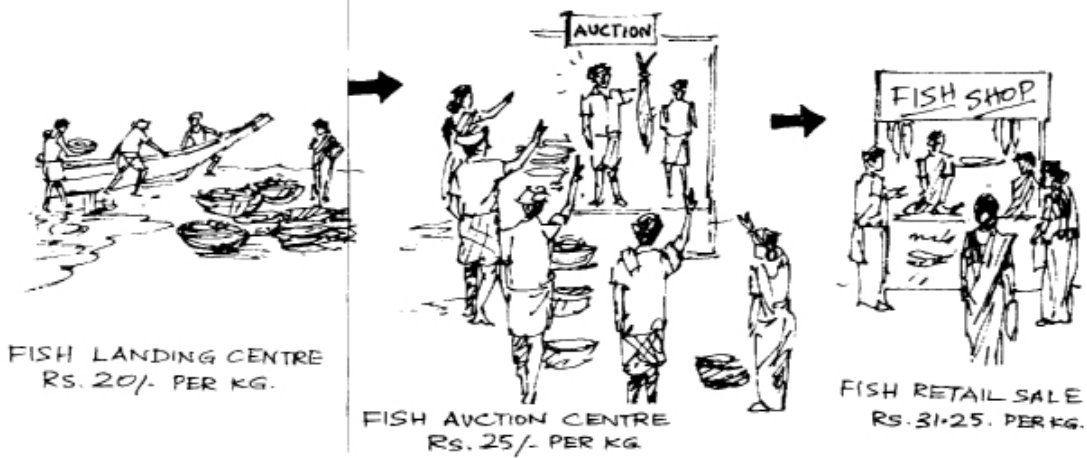
Divide the participants into 2 or 3 groups. Each group is given a specific business area and asked to list the various aspects to be considered before making a buying decision and to present them before the class. A general discussion should follow the presentations, guided by the trainer, who should ensure that the important aspects are brought out.

Some important aspects of purchasing

- Where to buy.
- Quality
- Price.
- How much to buy.
- When to buy.

Where to buy

Every product, before it reaches the consumer, goes through a number of hands. The sequence of exchanges from the primary source (place of production) to the consumer is called the **distribution chain**.



When you buy from the primary source, the price will be less compared to the price at any other point in the distribution chain. The difference in price is due to expenses on packing, loading and unloading, transport, warehousing and the profit of the middlemen at each stage. However, it is not easy for a small trader to buy from the primary source for these reasons:

- Goods will not be sold in small quantities at the primary sources.
- They may insist on cash payments.
- It may not be economical or convenient to transport small quantities.

RELIABILITY OF THE SUPPLIER

Reliability of the supplier is more important than price and payment terms. If the supplier is not reliable, the retailer will not be able to keep up supply commitments, leading to customer dissatisfaction. A fair assessment of the supplier can be made on the following basis:

- How long the supplier has been in business.
- What reputation he has got among his customers.
- How big the supplier's business is.

- Whether he would supply good quality material at a reasonable price.
- Whether he would be interested in doing business with you, considering the size of your requirements.
- Whether he would be interested in offering credit to you.

ALTERNATE SOURCES

Though a particular supplier is able to meet the requirements of a business, it is always advisable to find and maintain contact with additional suppliers. This will be of help if the main supplier fails to meet supply needs.

Quality

Quality is how well the product will stand up to its intended use – its ability to meet the requirements of a customer.

In a buying decision, price is not the only aspect to be considered. Besides price, quality is an important factor. The quality of the raw material will often determine the quality of the finished product, which, in turn, will determine customer satisfaction.

Generally, quality and price are directly correlated, *i.e.* the price of a product would vary with the quality of the product – lower if quality is poor and higher if quality is good. It is important to ensure that customers would be willing to pay a higher price for better quality.

Price

Price depends on the following factors:

- Quantity purchased.
- Payment terms.
- Quality.

QUANTITY PURCHASED AND PRICE

The price of a product depends on the quantity purchased. The more we buy, the more the profit to the supplier. Hence he may be interested in parting with a portion of his profit if he can sell larger volumes. This is called quantity discount.

An illustration may be introduced to explain how it may be more profitable to offer a discount for immediate payment than extending credit and charging interest for the credit period. The illustration should highlight:

- . Normally the profit margin is higher than the rate of interest.
- . Opportunity to turn round the money many times within the credit period earning the profit margin in each rotation.

Price also depends on the payment terms. The price offered for immediate cash payment will be much lower than credit price. The reasons for lower price for cash payment are:

- Cash payment is safe, from the supplier's angle.
- The supplier has to pay interest on the money locked in extending credit.
- Normally, the profit generated in a business is more than the interest rate. Therefore, if immediate payment is received, the supplier will be able to reinvest the money in his business and earn more profit.

How much to buy?

Every time something is bought, it involves some expenses, such as transport, travelling expenses of the person who goes to buy the material etc. This is called cost of buying or buying cost. Therefore, buying small quantities often means incurring more buying costs. Buying costs can be minimized by purchasing larger quantities each time and keeping the surplus, if any, in stock. However, keeping goods in stock means incurring certain expenses, such as interest on money locked in stocks, losses due to deterioration of quality, spoilage, spillage etc. These expenses are called **carrying costs**. Therefore, how much to buy is a question of minimizing the total of buying and carrying costs.

Consider the following example:

A trader sells 1800 pineapples at Rs.10/- per piece in a month of 30 days. Buying cost is Rs.11.25 every time he buys a stock of pineapples. Experience shows that the average cost of carrying stocks works out to Rs.0.10 per pineapple bought.

The following table shows the cost of buying a stock of pineapples, their carrying costs and total costs when the quantity of pineapples purchased at a time varies.

| Qty. purchased at a time | No of purchases in a month | Cost of buying every time (Rs.) | Cost of buying for the month (Rs.) | Carrying costs (0.10 per fruit) (Rs.) | Total cost (Rs.) |
|--------------------------------|----------------------------------|--|---|---|------------------------|
| 1800 | 1 | 11.25 | 11.25 | 180.00 | 191.25 |
| 900 | 2 | 11.25 | 22.50 | 90.00 | 112.50 |
| 600 | 3 | 11.25 | 33.75 | 60.00 | 93.75 |
| 450 | 4 | 11.25 | 45.00 | 45.00 | 90.00 |
| 360 | 5 | 11.25 | 56.25 | 36.00 | 92.25 |
| 300 | 6 | 11.25 | 67.50 | 30.00 | 97.55 |

From the table it is evident that the most appropriate quantity to buy is 450 pineapples, when total cost is the least, *i.e.* Rs.90.

Note, however, that purchasing and stocking decisions should not be taken merely on consideration of cost savings alone. More important aspects, like demand, shelf-life of the products, (how long the product can be stored without it getting spoilt), storage space, possibility of business coming to a stop due to nonavailability of stocks, etc., should also be kept in mind.

When to buy

This depends on the minimum stock required to be maintained and the time taken to replace the material used.

Continuing the pineapple example, let us *assume it takes two days to get the material from the date of placing the order*. So at least two days' requirement should be in stock.

Daily sale = $1800/30 = 60$ pineapples

Minimum quantity required to be maintained in stock = 2 days' sale = 120 units.

Sale of the product during delivery period = $2 \times 60 = 120$ units.

Therefore, the trader should place an order whenever the stock level is 240 units. This level of stock is called the re-order level. If the trader places the order at this level it will take care of the sale during the delivery period as well as the minimum stock required.

Though concepts of economics in buying and stocking have been introduced to make the consultant aware of such tools, the practical problems of great distances, poor communication facilities, and transport problems may be crucial to a microenterprise. Under these conditions, the uninterrupted conduct of business is a more important consideration than advantages in purchasing.

Collective buying

Microenterprises are, generally, likely to be in a weak bargaining position due to their limited resources and size of operations. They can overcome this disadvantage by organizing themselves and buying collectively. Collective buying will help in negotiating better prices and payment terms.

For example, vegetable vendors in Indian towns and cities face difficulty in transporting their goods from the main markets to their shops. Due to the small quantities involved, they cannot afford to hire private transport and, therefore, depend on local bus transport. The bus operator.v know the vulnerability of the vendors and often cheat them. Vegetable vendors have, therefore, started hiring small motor vans collectively. This enables them to have

reliable and trouble-free transport for their purchases to their doorsteps.

Such co-operation may be extended to pooling their money to buy vegetables collectively, so that they get a better price (due to volume buying) as well as better terms of payment.

The consultant could play a catalytic role in organizing and motivating small businessmen in evolving such innovative ideas for their benefit.

For example, an outboard motor mechanic in a fishing village may not be able to afford to keep a stock of spare parts as the need for them may be irregular. Yet, the parts are available only in cities and towns that are far away. If a motor breaks down and spare parts are not available, the boat will be out of service and

the fishermen will lose their income. The consultant, in this instance, could persuade the local fishermen's cooperative, if any, to keep a stock of crucial spare parts. The mechanic could buy the parts readily from these cooperatives whenever a need arises. The cooperatives could add a small margin for their costs. Thus, everyone would gain.

THINGS TO REMEMBER

- Goods pass through a distribution chain before they reach the customer. The prices will be lowest at the primary source (place or production) and highest at the retail shop. But a retailer may not be able to buy at the primary source for these reasons:
 - Goods will not be sold in small quantities at the primary source.
 - It may not be economical to transport small quantities from the primary source.
- If the supplier is not reliable, the business will be affected and customers will be dissatisfied.
- It is advisable to have two or three suppliers for the smooth running of the business and to get better prices, payment terms and service.
- In a buying decision, price alone is not the consideration. Quality is an important aspect. Good quality will ensure customer satisfaction. However, customers should be willing to pay a higher price for better quality.
- Price depends on quality, quantity purchased and payment terms.
- If the number of times purchases are made during a certain period are many, buying expenses will increase but the expenses incurred on carrying stock will decrease. If the number of times purchases are made is few, buying expenses will be less, but stocking expenses will be more. The optimum number of purchases is when the total expenses (buying + stocking) are the least.
- When to buy (re-order level) depends on the minimum stock required to be maintained and the time it will take to replenish the stock.
- Purchasing decisions should be taken based not merely on economics but considering practical problems likely to be faced by microenterprises, such as great distances, and poor transport and communication facilities.
- Collective buying can improve the bargaining power of microenterprises.

Stocking

9

What are we going to look at in this chapter?

- What is meant by stocking
- Need for maintaining stock
- Consequences of inadequate stocking and overstocking.
- Estimation of optimum stock.
- Proper storing

What is 'stocking'?

Stocking may be defined as ensuring availability of raw materials, consumables and finished goods of the right kind in adequate quantities in order to meet the business requirements of production or sale,

Divide the participants into two groups. Let the two groups separately discuss the need for stocking and how to decide on how much

Stocking **ensures** the smooth and uninterrupted running of a business.

to stock. Then, get them to present their views.

Need for maintaining stocks

- The source of supply may be far away from the place of business.
- If the material is 'made-to-order', it may take time to produce.
- Trading involves buying goods in large quantities and selling small quantities, as the individual requirements of customers are likely to be small, *e.g. bolts and nuts may be sold by wholesalers by weight, while they may be required only in small numbers by actual consumers.*
- The material is always in short supply or the availability of the material is seasonal.

How much to stock

We now know that stocking is essential for the smooth running of your business. But the question is how much to stock.

If the quantity stocked is inadequate, there will be not enough goods or raw materials available to sell and make the profit

necessary. On the other hand, if the stocks maintained are very large, then a lot of money may be locked up unproductively. In both instances, the business could lose.

Stock-out

Stock-out is a situation where there are no goods to sell or no material to carry on the production activity. This is caused by insufficient stocks. The stock-out situation results in loss of business, defaults in delivery commitments and customer dissatisfaction.



Overstocking

Overstocking is keeping substantially larger stocks than required. This results in money being unnecessarily locked up in stocks. The interest on the money so locked up eats away the profit. Money has a cost, even if it is not borrowed, as it will earn interest if it is invested elsewhere. Besides interest, overstocking may result in a product becoming outdated. There may also be losses due to spoilage, leakage and thefts.



Optimum stock is the ideal level of stocking at which the business will run smoothly, without interruption, and, at the same time, involve only the absolutely minimum amount of money necessary being locked up in stocks.

Optimum stock level depends on the following factors:

- The rate of consumption or sale.
- The time required to replace the material consumed.
- Perishability of the goods.

Illustration

Rukmini has a grocery shop in her village. Her experience shows that the average sale of a particular brand of beedis is ten bundles a day. The delivery man visits the village once in a week. At times he takes even ten days. She wants to know what is the optimum stock of beedis she should hold.

Daily consumption — 10 bundles
Replacement period — 7 days

| | Bundles |
|---|---------|
| Sales during replacement period | |
| 10 bundles x 7 days | 70 |
| Add for safety: 10 bundles x 3 days (since experience shows he may take even ten days) | 30 |
| Optimum stock | 100 |

Storage

It is very important to ensure that stocks are stored properly. Good storage helps in:

- Readily locating the material in stock when required.
- Minimizing the loss due to spoilage in the case of perishables, spillage in other cases.
- Preventing and detecting thefts.
- Giving an impression of neatness and order.

NEATLY STORED



DISORGANIZED



THINGS TO REMEMBER

- Stocking ensures smooth running of a business.
- Inadequate stocking results in customer dissatisfaction and loss of business.
- Overstocking causes erosion of profits due to interest cost. It also results in goods getting spoilt, losses due to leakage, spillage etc.
- Optimum stocking depends on the rate at which the goods are sold or consumed and the time taken to replenish the goods.
- Good storage is essential to store the goods with ease, and prevent loss due to spillage, leakage and thefts. Further, it gives a business an impression of neatness and order.

DEMAND & SUPPLY



↑ MORE DEMAND

HIGHER PRICE ↑



↓ LESS DEMAND

LOWER PRICE ↓



SUPPLY



↑ MORE SUPPLY

LESS PRICE ↓



SUPPLY



↓ LESS SUPPLY

MORE PRICE ↑

Pricing

10

What are we going to look at in this chapter?

- What pricing is.
- Factors that affect pricing.
 - Demand and supply.
 - Perishability of the product.
 - Seasonal factors.
 - Volume of sales.
- Elements of price.

What is 'pricing'?

Pricing refers to setting a 'cash' value, or price, on any product or service.

Pricing is a crucial decision in any business activity, because if it is not done properly, or elements of costs, like overheads, are ignored, then the business could be at risk with wrong pricing, there could be a mistaken impression that the entrepreneur is making profits whereas, in actuality, he would be incurring losses.

Factors that affect pricing

Several factors affect pricing, such as:

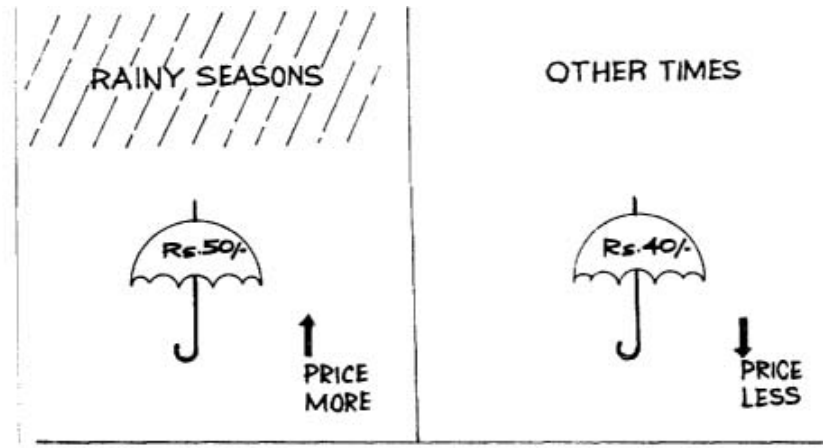
- Demand and supply.
- Nature of the product.
- Seasonal factors.
- Volume of sales.
- Terms of payment cash / credit.
- Cost of goods.

Let us consider them in detail

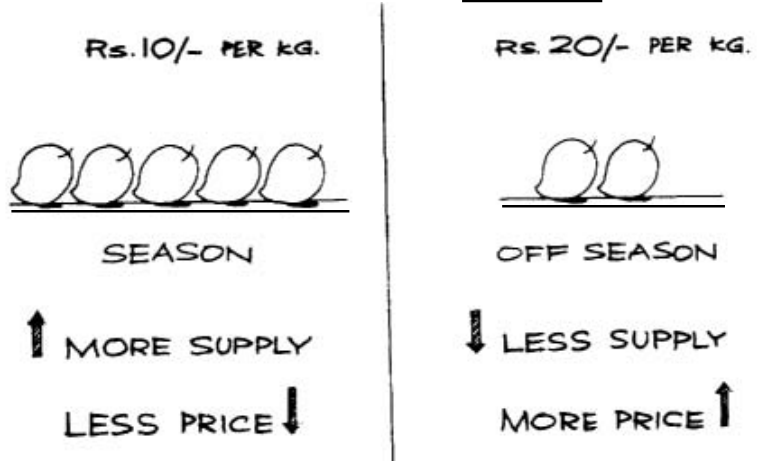
Demand and supply

The major factors affecting the price of a product are the demand and supply for it. **Demand** is the requirements or needs or wants of the people. Supply means the availability of the product or service. A fundamental rule of price behaviour is that, as the **demand for a product goes up, the price also goes up**. As **supply of the product increases in the market the price reduces**.

SEASONAL DEMAND



SEASONAL SUPPLY



By nature of the product we mean whether it is **perishable** (like fresh fish, fruits & vegetables) or **durable** like cloth or utensils.

Perishable products have very short shelf-life and have to be sold within that period, even at a lesser price, in order to minimize losses. If not, this will result in a total loss. This is not so in the case of durables. With durables, the seller only has to incur the additional carrying cost. This cost should be duly reflected in the price fixed.

A simple illustration to quantify the loss in the case of perishables and carrying cost in the case of durables may be introduced in a discussion.

Seasonal factors

Certain products are seasonal and are available in plenty during their season. Hence the price tends to be higher at the beginning and end of the season and lower during the peak of the season e.g. *Seerfish*.

Volume of sales

Volume of sales will also affect price. The higher the volume, the lower the price per unit. The reason is that, though the price and, consequently, the profit per unit is lower, the total amount of profit earned will be higher when the numbers sold are more.

Illustration

Sita is a fruit vendor. She purchases mangoes at Rs.24/- a dozen. If she sells the mangoes at Rs.30/- a dozen she can sell ten dozens. If she sells at Rs.29/- a dozen, she can sell 15 dozens. The results will be as follows:

| <i>Selling price</i> (Rs.) | <i>Profit</i> <i>per dozen</i> (Rs.) | <i>Sale</i> <i>qtv.</i> (dozen) | <i>Total</i> <i>profit</i> (Rs.) |
|-------------------------------|--|---------------------------------------|---|
| 30 | 6 | 10 | 60 |
| 29 | 5 | 15 | 75 |

Raise the issue for discussion. Whether an entrepreneur should
- sell less at a higher price

or
- sell more at a lower price

This example illustrates that, under certain circumstances, selling larger volumes enables a product to be offered at a lower price, yet the seller's total profit is increased.

Elements of price

The price charged should cover — the cost of the goods, — the seller's fixed expenses, and — a reasonable profit.

These are the elements **of price**.

Let us examine the various elements in detail.

Cost of goods or 'direct cost'

The cost of goods should include the price the goods were bought at, local taxes levied, if any, and cost of freight incurred to transport the goods from the source to your place of business. If the freight is incurred on more than one type of goods, it should be spread over the different purchases. The cost arrived at by this method is also called, cost **of purchases** or **direct cost**. It is also called **variable** cost or **variable expense** as it varies, or changes, in direct proportion to the volume of business.

Illustration

Manikkam, a vegetable vendor, purchased 25 kg of potatoes at 5 Rs/kg and 20 kg of tomatoes at 7 Rs/kg and 20 kg of brinjal at 4 Rs/kg. He incurred a cost of Rs.15/- for transporting the vegetables from the market to his shop.

Let us compute the direct cost for each type of vegetable for the purpose of pricing.

Since Manikkam is going to sell all three types of vegetables by weight, let us adopt weight as the basis for distributing the transport cost.

| | | |
|--|---|----------------------------------|
| Total freight incurred | - | Rs.15 |
| Total weight of vegetables | - | 65 kgs. |
| Cost of transport incurred per kg of vegetable | - | $\frac{15}{65} = \text{Rs.}0.23$ |

The direct cost per kg of vegetables would then be as follows:

| | Potatoes | Tomatoes (Rs./kg) | Brinjal |
|------------------------------|----------|----------------------|---------|
| Purchase price | 5.00 | 7.00 | 4.00 |
| Transport | 0.23 | 0.23 | 0.23 |
| Cost of goods or Direct cost | 5.23 | 7.23 | 4.23 |

This is simple, because the case we have taken is a trading enterprise. Ascertaining direct cost in the case of a manufacturing or service enterprise is slightly more complicated.

Direct cost in the case of a manufacturing enterprise

In a production or manufacturing enterprise, the direct cost includes the cost of materials and labour and other expenses which can be directly identified or related to the activity of the enterprise.

Sagaya Mary is a basket-maker. She requires 1',kg of palm leaves to make one basket. She also requires 1 kg of pigment, at 10 Rs/kg to paint 100 baskets. She employs three persons to weave

baskets and pays Rs. 2.50 for weaving one basket. Sagaya Mary purchased 100 kg of palm leaves and one kg of pigment in the market and incurred a cost of Rs. 10 to transport them to her shed. Compute the direct cost of making one basket.

Since pigment is insignificant in weight and value compared to palm leaf, the cost of transport of pigment is ignored.

| | | | |
|-----------------------------|--------|--------|------------|
| Total weight of palm leaf | 100 kg | | |
| Total freight incurred | | Rs. 10 | |
| | | 10 | |
| Freight per kg of palm leaf | = | | = Rs. 0.10 |
| | | 100 | |

Cost of material per kg

| | Price Rs. | Freight Rs. | Total Rs. |
|------------------|--------------|----------------|--------------|
| Palm leaf per kg | 2.00 | 0.10 | 2.10 |
| Pigment per kg | 10.00 | — | 10.00 |

Direct cost of production of basket

| item | Qty. Kg. | Rate Rs. | Value Rs. |
|-------------------------------|-------------|-------------|--------------|
| Palm leaf | 1.5 | 2.10 | 3.15 |
| Pigment | 0.01 | 10.00 | 0.10 |
| Cost of materials | | | 3.25 |
| Labour | | | 2.50 |
| Direct cost per basket | | | 5.75 |

DIRECT COST IN THE CASE OF A SERVICE ENTERPRISE

Raman is a fisherman who also owns a vulcanizing shop. The shop is looked after by his brother-in-law Krishnan, to whom Raman pays a monthly salary of Rs.600/-. In Raman's experience, the shop fixes about twenty punctures a day. The shop works for 25 days in a month. Cost of material required to fix one puncture is Rs.1.50. Raman wants to know the direct cost involved in fixing a puncture so as to fix a correct price.

| | |
|---|--------|
| Average number of punctures fixed/day | 20 |
| Average number of working days/month | 25 |
| Average number of punctures fixed/month (20x25) | 500 |
| Salary paid to Krishnan for a month | Rs.600 |

Average cost of labour for fixing a puncture =

$$\text{Rs. } \frac{600}{500} = \text{Rs. 1.20}$$

| | Rs. |
|--------------------|-------------|
| Cost of material | 1.50 |
| Cost of labour | 1.20 |
| Direct cost | 2.70 |

Fixed expenses

Besides direct costs, an enterprise also incurs certain **fixed expenses** or **overheads**, like rent, electricity, salaries (other than piece rate wages) etc. These expenses are termed fixed because they have to be necessarily incurred, irrespective of the volume of business. They have the following typical characteristics:

- They do not vary with the volume of business.
- They cannot be directly identified or related to a unit of product or service of the enterprise.
- They are generally related to a specific period and are, hence, also called **period** costs.

It is essential that the price should not only cover the direct costs but should be sufficient to recover the indirect expenses or overheads.

The subject of variable and fixed expenses is further discussed in Chapter 16, 'Break even analysis'.

Profit

Profit is the difference between the sale price and the cost of goods. Profit can be classified as:

- gross profit; and
- net profit.

GROSS PROFIT

The difference between the sale price and the direct cost is called the **mark-up** or **margin**. The mark-up multiplied by the quantity sold yields the gross profit or **contribution**. The mark-up is generally determined by market conditions.

NET PROFIT

Net profit is the difference between the value of sales and total cost (direct cost plus overheads). This is also the balance remaining after deducting the overheads from the gross profit or contribution.

Illustration

Mumtaz bought 100 kg of potatoes at 5 Rs/kg, 50 kgs of tomatoes at 6 Rs/kg, 40 kgs of brinjal at 4 Rs/kg. She sold them at 6, 7 and 5 Rs/kg respectively. Let us compute the mark-ups, gross profit or contribution for each of the products.

| | Potatoes | Tomatoes | Brinjal |
|-----------------------------|----------|----------|---------|
| 1. Quantity (kg) | 100 | 50 | 40 |
| 2. Cost (Rs.) | 5.00 | 6.00 | 4.00 |
| 3. Selling price (Rs.) | 6.00 | 7.00 | 5.00 |
| 4. Mark up (Rs.) | 1.00 | 1.00 | 1.00 |
| - as % of cost | 20% | 16.67% | 25% |
| Gross profit (1 x 4) in Rs. | 100.00 | 50.00 | 40.00 |

Illustration

Vinod owns a fish shop. He normally sells about 500 kg of fish in a month. The present purchase price of fish is 15 Rs/kg. He employs a shop assistant on a salary of 350 Rs/month. He also pays a shop rent of 300 Rs/month. Electricity charges are 30 Rs/month. What price should Vinod sell his fish if he wants to make a net profit of 1000 Rs/month?

FIXED EXPENSES

| | Rs. | Rs. |
|-----------------------|-----|------|
| Salary | 350 | |
| Rent | 300 | |
| Electricity | 30 | |
| | | 680 |
| Net profit required | | 1000 |
| Gross profit required | | 1680 |

$$\text{Mark-up} = \frac{\text{Gross profit}}{\text{Sale quantity}} = \frac{1680.00}{500} = 3.36 \text{ Rs/kg}$$

$$\text{Sale Price} = \text{Direct cost} + \text{Mark-up} = \text{Rs.15.00} + \text{Rs.3.36} = \text{Rs.18.36}$$

EXERCISE

Nagamma has decided to set up a vegetable shop in a little village where there are about 120 families. Since there are no shops nearby, she guesses it will be a profitable thing to do.

She has decided to sell the following vegetables:

Potatoes. Tomatoes, Cabbage, Lady's fingers. Ginger, Onions. Greens, Chillies

She has made enquiries and identified a shop where she can make purchases at a good price. She has decided that her selling price should be cost + a margin of, say, 30% for the main vegetables and 100% for the smaller items (ginger, greens and chillies). She has also decided to round off the selling price for the sake of conveniently measuring out smaller quantities.

During one week, she bought the following vegetables at the rates indicated against them:

| <i>Vegetable</i> | <i>Unit</i> | <i>Cost Rs</i> | <i>Margin %</i> | <i>Selling price</i> |
|------------------|-------------|--------------------|---------------------|--------------------------|
| Potatoes | Kg | 3.00 | | |
| Tomatoes | Kg | 4.00 | | |
| Cabbage | Kg | 2.50 | | |
| Lady's fingers | Kg | 3.00 | | |
| Onions | Kg | 2.50 | | |
| Ginger | piece | 0.25 | | |
| Greens | Bunch | 0.50 | | |
| Chillies | heap | 0.25 | | |

She has to pay a rent of Rs.50 per week and, on an average, for a week incurs Rs.50 as transportation and conveyance charges.

Work out the selling price of each of the above vegetables.

During another week, she bought the following:

| <i>Vegetable</i> | <i>Qty. Kg.</i> | <i>Rate Rs.</i> | <i>Cost in Rs.</i> | <i>Sale value Rs.</i> |
|------------------|---------------------|---------------------|------------------------|---------------------------|
| Potatoes | 20 | 3.00 | 60 | |
| Tomatoes | 10 | 4.00 | 40 | |
| Cabbage | 6 | 2.50 | 15 | |
| Lady's fingers | 30 | 2.50 | 75 | |

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- 1) What should her total sales value be in order to recover her over-head costs of Rs.100 for the week.
- 2) What is her element of profit at this level?
- 3) Fix the sale price of each vegetable in order that she is able to recover her fixed costs of Rs.100 plus a profit of Rs.90 per week.

ACTIVITY

Rama Rao has a cycle repair shop in Chalapet, a fishing hamlet on the Andhra coast. He has been running this shop for the past three years and caters to about 200 cyclists in and around his village. Rao's shop has an excellent reputation and his customers are normally satisfied with his service. His customers normally do not complain about the charge that he asks.

Rao has his little shop near the main bazaar in the village and has two persons helping him. He has a large trunk in which he keeps his tools and materials. Rao renders the following services:

Filling air
Overhauling

Mending punctures
Minor repairs

Rao charges his customers more or less fixed prices, but gives a small discount to his 'old' (regular) customers.

One day, when the consultant visited him, she found him rather agitated. He came up to her and said 'Do you know Babu who used to work here?' He has left me and started his own cycle repair shop in the next lane. What do I do now? Of course, my regular customers are still coming to me, but I am still worried. Moreover, his charges are cheaper. Should I reduce my rates? Please advise me".

What would your advice be?

Discuss this case with respect to pricing, considering the following aspects:

Should Rao reduce his rates?

Should his rates be linked to Babu's rates?

Flexible pricing may also be introduced as a concept. Discuss the Entry Pricing strategy adopted by Babu, under what circumstances it will succeed etc.

CASE STUDY

Farhana is an enterprising person who is, today, the proud owner of a grocery shop in a town. Over the years she has managed to expand her business and, today, supplies to the hotel, revenue office and the cooperative bank in the town, besides, of course, the townsfolk. But a major share of her sales is to the P.W.D. travellers' bungalow which is a busy little place.

But Farhana was not a very happy woman when the consultant visited her. Their conversation ran as follows:

Farhana: I don't know what is wrong with my business. I keep selling and at good prices, but I am always out of cash.

Con: Credit is a normal feature in any business, provided you handle it carefully. You should probably be more careful in giving credit or, perhaps, you should keep a better record of your dues.

Farhana: That's really not my problem. None of my customers have defaulted till now. What I am surprised is how Sheru across the road, who supplies hardware to the same people I supply groceries to, doesn't seem to have this problem.

Con: Look here, Farhana, why don't you clearly identify your problem. Maybe we can do something about it.

Farhana went on to describe her problem:

Farhana: My problem is really the P.W.D. The travellers' bungalow accountant is unwilling to pay me cash and goes on extending the credit period. How do I tackle this?

(contd.)

(contd. from previous page)

Con: Have you approached the accountant in the P.W.D. office and discussed your problem? What exactly did you tell him?

Farhana: Of course, I did. I have told him several times to give me cash on delivery or, at least, pay me on the due date. But he only asks me to come back at a later date,

Con: Why don't we discuss it with him again tomorrow morning. Maybe he has not really understood your problem. Be sure to bring the details of how much he owes you.

The next morning Farhana goes to the P.W.D. office and the consultant accompanies her.

The conversation at the P.W.D. office ran as follows:

Farhana: Good morning, Mishraji. I have come to discuss with you the amounts that your department owes me and that too for a very long time.

Accountant: As long as you want to discuss it, I do not mind. But please do not ask me to pay you any amount this week. By the way, who is this person?

Farhana: This is Ms. Kumar. She is a friend of mine and helps me out with my business sometimes.

After the introductions are over. Farhana earnestly returns to the problem at hand.

Con: We are finding it increasingly difficult to supply you items for which you are not paying us cash. We cannot say the same to our supplier, who demands his payment in advance.

Accountant: I feel sorry for you. But considering the Government's position today, I have been instructed to make payments only after they have been specifically approved by my head office. Each time I forward your bills, he says he will pay it the next time. There is not much that I can do.

Farhana: But Sheru seems to be getting his dues on time!
(excitedly)

Accountant: Sheru agrees to give us a prompt payment discount up to 2% of the value of the bill. This is good enough for my officer to recommend immediate payment, since he would be able to explain that there has been some savings. I have, in fact, mentioned this to you.

Con: Why don't you, please, tell us what exactly we should do and we will consider whether we can do it.

The accountant explains the procedure. Farhana and the consultant go out and discuss the accountant's suggestion for a few minutes. When they return, Farhana promises to give him a letter offering to give a discount of 2% for immediate payment.

Farhana and the consultant leave the office. Outside, Farhana says. "Thank you, Ms. Kumar. You have really done me a great service".

This case will highlight flexible pricing.

Discount for prompt payment Why?

Cash inflow: Importance of cash today rather than tomorrow.

Cash is lifeblood of business.

Incidentally, also talk about discounts for large volume purchase:

Turnover discount: Why should we do this?

Larger turnover with one customer less time-consuming.

THINGS TO REMEMBER

- Pricing is assigning a monetary (cash) value, or price, to a product or service.
 - Pricing is a crucial function, as it affects:
 - Survival of the business in a competitive environment; and
 - Profits and growth
 - In a free economy, control over price is generally not in the hands of the business. It is determined by the demand and supply position.
 - More demand: higher price:
 - Less demand: lower price
 - More supply: lower price:
 - Less supply: higher price
 - Price should cover not only the direct cost. or expense. hut also the indirect, or fixed expense, as well, besides including a reasonable profit to the owner.
-

Selling

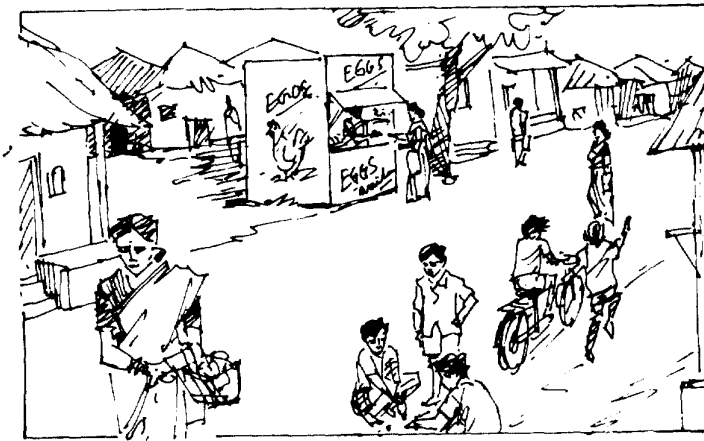
11

What are we going to look at in this chapter?

- Features of selling
- Rules for successful selling
- Attributes of a successful salesperson.

What are the special features of 'selling'?

You must know **the customer** and choose the **right location**.



The vendor knows the housewife is the person who decides on buying eggs. He knows that her childrens nutrition is a concern to her

Who will the mother buy eggs from?

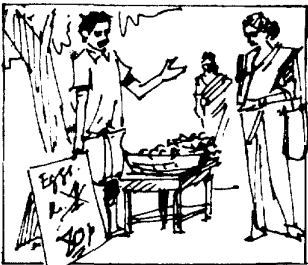


Pleasant-looking, clean people attract customers. **Attractive display** of products increases sales.



Small things sold along with the main product make the product easier to sell.

People do come to a shop with a 'plan' to purchase an item — **planned purchase**. However, at the shop, they change their mind, depending on what they find there and make an **impulse purchase**.



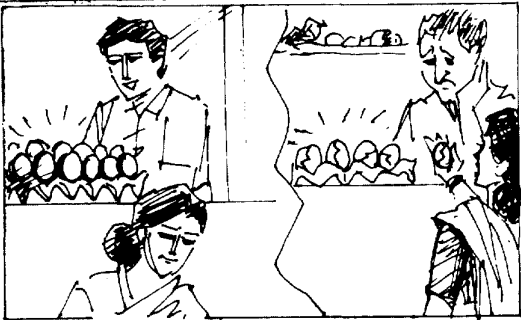
A **discount** in price can help this vendor sell his eggs faster. The discount is used to sell the products before they spoil, because after they spoil they will have no value.

A discount, or an incentive, can also be offered to people to make them try a new product.

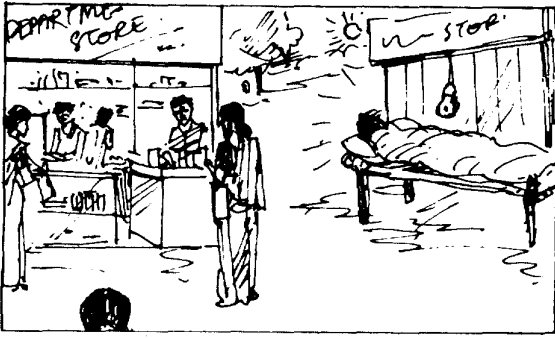


The vendor has built up the **confidence** of his customer with

- immediate service, and
- honesty: she trusts him because she knows he will not cheat her



Products should be of **good quality**.



The service should be prompt.

Rules for successful selling

Greet the customer courteously.

Ask questions, rather than recite facts.

Show the product and explain its features.

- Help the customer to come to a decision at his/her own speed.
- Allow the customer to say 'no' without disagreeing, if this is in the customer's best interest.
- Expect and welcome objections.

Answer questions and objections carefully and truthfully.

Understand each customer's wants.

A successful salesman NEVER

argues. The argument may be won, but the sale is lost.

loses his **temper**. Losing your temper will always result in loss of sale.

makes exaggerated claims. The truth will eventually come out.

forces the product on a customer.

- **interrupts the customer**.

shows disrespect to the customer, in the way s/he dresses, talks, looks etc.

- **allows credit** beyond the customer's ability to pay.

encourages more purchases than what the customer needs or can afford.

ACT!VITY

Divide the participants into three teams.

Team 1 to set up a tea shop

Team 2 to sell 25 tender and 25 mature coconuts produced in the farm.

Team 3 to sell a tailoring service.

Each team to work on

- to whom they would sell;
- what they would sell;
- where they would sell;
- how they would sell; and
- what the additional areas would be that they would take care of and how they would do it.

THINGS TO REMEMBER

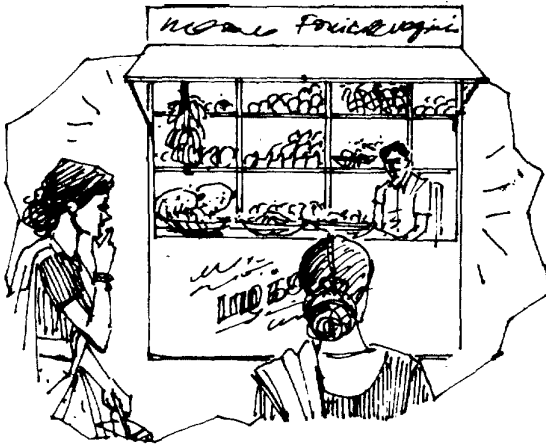
- To sell effectively you must know to whom you are going to sell.

You should sell to the person likely to use the product.

- What are you selling?

What is the need/requirement being met by your product?
What are the benefits of buying your product?

- Where should you sell? Where is your product most likely to be bought'?
- The person selling should be clean and pleasant. Cleanliness makes products attractive.
- The products/wares should be well-displayed and you should be able to explain what is special about them. Attractive displays attract the attention of customers and create a desire to buy.



- Products should be of good quality.
- Signboards attract customers: use them wherever possible,
- Products/Services should be made available on time. Service should also be prompt.
- Small items sold along with main items help to attract customers.
- The customer should be confident that you will never cheat him/her. You should win his/her trust,
- Discount sales help to clear old stock.
- Discounts/incentives help to makes customers try your product.

Distribution

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What are we going to look at in this chapter?

- The need for a distribution system
- The process by which the product reaches the buyers.
- The people involved in this process *i.e.* middlemen and their role.

What is 'distribution'?

The process by which the product reaches the consumer is called distribution. This can be seen clearly in the illustrated sequence alongside:

The important people in the distribution system are

Producers.

Middlemen - there could be several of them, depending on how far the consumer is from the place of production.

Retailers

The function of the distribution system is to **transport and store** the products till it reaches the consumer.

Ideally, a farmer growing grain should sell directly to the retailer. His grain will not have to pass through the hands of several middlemen and, thereby, he will be able to get a much better price.

Then why is there a distribution system?

D I S T R I B U T I O N



FARMER HARVESTING CROP

CROP BEING TAKEN
TO LOCAL MARKETS

BEING BOUGHT AND STORED BY
GRAIN MERCHANTS IN GODOWN

WHOLESALE FROM
VARIOUS PARTS OF THE
BUY FROM
THE GRAIN MERCHANTS.

TO THE GODOWN

TRANSPORTING THEM
TO RETAILERS
AS AND
WHEN NECESSARY.

CUSTOMER BUYING FROM RETAILER
AT LOCAL SHOP.

The costs involved in **transportation and storage of** the produce till it reaches the consumer would be too high for the farmer to bear.

He will waste a lot of time which he would be otherwise able to use in producing more his area of expertise.

He may not be able to reach the buyer easily at the right time and the right place.

How does the distribution system reduce the costs, involved in reaching the consumer?

The middlemen make it possible for the system to work because they handle larger quantities.

They also have the money required to buy from many farmers, invest in a godown to store all their purchases and bear the transportation expenses. They also know where to sell the produce.

The middleman therefore leaves the farmer to concentrate on producing while he takes care of the rest.

ACTIVITY (Discussion Guide)

Initiate discussion on:

Select some examples for each:

- Whether participants think middlemen and the distribution system are necessary for all products.
- When and for what products it would be necessary.
- When and for what products it would not be necessary.

Guide discussion to highlight when middlemen are needed:

Middlemen necessary

Small quantity produced and market is far away.

Large quantity produced, but market is difficult to reach,

When money is required quickly to meet working expenses.

Middlemen not necessary

Small quantity produced and likely to be locally consumed.

Large quantity produced and market is not too far — provided transportation is available to reach the market in time and return at regular intervals.

Producer capable of investing in stocks and has enough for operating expenses.

What are the characteristics of a good middleman?

To BE HIGHLIGHTED: A good middleman would

- Be a local person of good financial standing;

- Be willing to hold stock (would be equipped to do so);
- Create a steady demand for the product;
- Be a good communicator (communicating the needs of the market to the producer and helping him to produce what the market needs); and
- Be able to take on the risks of a small-scale manufacturer! entrepreneur.

Ask for examples of how good middlemen have, in their experience of the participants, helped enterprises.

Who is a bad middleman?

TO BE HIGHLIGHTED: A bad middleman is one who

- Exploits the producer;
- Will not give a steady return to the producer;
- Will try to reduce the prices; and
- Has no interests in the welfare of the producer as he is not a local person. (As his roots are elsewhere, what happens locally does not bother him.)

Is it possible for you, as a consultant who advises the community, to help set up/find middlemen who could help the microenterprise entrepreneur. How would you do it?

TO BE HIGHLIGHTED: The way it could be done is by:

- Identifying the market for the product.
- Tracing the distribution system for the product.
- Finding persons of reasonable financial standing who would be able to communicate with the producers and the market.
- Negotiating and setting up the distribution system.

THINGS TO REMEMBER

- Ideally a producer should get the best (highest) price for his product from the buyer.
- However, in most cases, it is difficult for the producer to sell his product to the buyer because
 - He is far from the buyer.
 - He does not know when and where the buyer is.
 - He needs money immediately for his production.
- It is therefore better to use a middleman who has:
 - Enough money to invest in the products;
 - Storage facilities to store for a period of time; and
 - Transportation facilities to reach the consumer.
- Middlemen therefore are a must when:
 - A small quantity is produced and the market is far away.
 - Large quantities are produced, but the market cannot be reached easily.
 - When money is required quickly to meet expenses.
 - When storage and transportation will eat into the producer's time for production.
- A good middleman is:
 - A local man who is financially sound.
 - A businessman concerned about the producer.
 - A person who will help the producer produce what the market needs.
- A bad middleman will exploit the producer and will not give him a steady return
- Before helping find a middleman
 - study the market for the product;
 - trace the distribution system; and
 - find persons of financially sound backgrounds who will be able to communicate with the producers and the market.