

Khazanay.com set their accounts straight

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The case written, by Asst Professor Usman Nazir (usmannazir@iba.edu.pk) and Faculty Member Haroon Tabraze (htabraze@iba.edu.pk) of Institute of Business Administration (IBA) Karachi, is solely for the purpose of class discussion. It is not intended to indicate any effective/ineffective handling of managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

Abstract

Khazanay.com, an online portal selling used stuff online, is started by two enterprising young individuals in November 2015, Usman and Farid. Setting up the business was a tough task to conquer for used goods business is different from regular trading because of the inconsistent quality of procured products and the additional complexity of grading the products for quality. Further, identical goods are non-existent as every item is unique. The marketing end is also complicated as customers know that the good is already used and would have signs of wear and tear. However, equipped with healthy corporate training, quality education, unwavering commitment and persistence in getting the idea to work, both entrepreneurs managed to develop and maintain a process where the business has become profitable within one year. Being professional accountants, both entrepreneurs are aware of the importance of Financial Reporting, and their accounting prowess has been one of the main factors of their success. This case study talks about the entrepreneurial journey and how financial reporting may help a start-up in the initial phase.

Keywords: *Entrepreneurship, Small Business Accounting, Accounting, Financial Statements*

Background

Usman and Farid were classmates and just like any other professional, had the aspiration of joining management positions at a large enterprise. After completing ACCA, Usman joined Ernest & Young, a big four accountancy firm. Accountancy firms were the rage at that time, as young professionals saw them as a route to foreign placements. However, Usman lost interest within a year and switched over to Pakistan State Oil (PSO). The remuneration was good, but the monotonous nature of a nine-to-five job was not alluring. A brief stint in marketing fascinated him towards product placements and he thought to explore it by doing MBA from a local institute.

Usman was a frequent visitor of the famous Sunday Bazar in DHA Karachi. Sunday Bazar was sort of a flea market; where people could hunt for good bargains. Many a times, Usman himself had found imported stuff that could not be found anywhere else; at very reasonable prices. While doing MBA, Usman read in a newspaper that DHA was ceasing holding of the Sunday Bazaar. Usman was disappointed by the news but the idea that Sunday Bazaar is a good bargaining place stuck to his mind somehow. Usman completed his MBA in 2014.

Farid joined Meezan Bank, the first Islamic bank in the country, after completing his ACCA and worked there for three years. While working at Meezan Bank, Farid found out the intricacies of Islamic Finance. During his work, he found that many organizations were holding different types of awards, but there was no award in the field of Islamic Finance. Being an entrepreneur, he thought to conduct Islamic Banking Awards. Equipped with his work knowledge, he compiled criteria (benchmark) that an Islamic Financial Institute can be measured for, and got it vetted from the industry experts. He quit his job, and organized the first ever Islamic Banking Awards in Pakistan. The event was a huge success, and got favorable media coverage. The experience strengthened his belief in himself and gave him the confidence to be an entrepreneur. After the successful completion of the awards event, Farid was looking for something to do and fate made him meet his old friend Usman, and they started brainstorming.

The Initial Struggle

The objective was to start something of their own; but what? While surfing the net for possible leads, they came to know that China imports chicken feet in large quantities. The consumption of chicken in Pakistanis is very high, but we throw away the chicken feet as waste. They thought that they would get the chicken feet at scrap value, and export them to China. The idea was strong but once they started working they realized that they do not have enough connections in the poultry business to procure the feet in sizeable numbers to enable them to export.

Their second idea was PET flakes. Used plastic bottles would be collected, and then cut into small pieces that would be exported to China for recycling. Farid explored the extensive network of garbage pickers that led him to the place that collects used plastic bottles and sorted them. Being Pashto speaking, Farid managed to get the required knowledge easily. However, their motivation evaporated when they found out that they need to invest in an industrial cutter, pay rent for a sizeable space to house the machine and to put bottles (raw material) and flakes, pay to laborers for packing, and generator for electricity. Farid had a strong suspicion that as soon as the bottle suppliers find out the demand, the procurement price would increase. After a lengthy discussion, they dropped the idea.

The next idea was online Islamic insurance comparison leading to purchase of policies. The concept is nothing new in the world, but there was nobody doing it in Pakistan. Pakistan being an Islamic state with a majority Islam practicing population has a strong inclination towards products and services that are Islamic. The idea was lucrative and sure win. They both decided to go ahead with it. Their first step was to get a web-portal made for the purpose. They named

it Chatri. Usman had a friend whose brother started a software house in the incubation space at IBA – a renowned business school in Pakistan. Usman and Farid approached the software house and got Chatri's website made. They also liked the incubation space offered by IBA and decided to get an office of their own there for Chatri. All was set and ready for Chatri but the entrepreneurs. The market was not as receptive to their idea as they thought it would be. They soon ran out of motivation. By now, however, they had learned how to bring an idea into reality.

The experience of working on Chatri introduced them to the opportunities offered by the ecommerce world. They had learned exactly what was required to setup an online business. However, getting it to run was another matter. This is where they needed advice and Usman's brother Sohaib, who was well experienced in the field of ecommerce, proved to be a wise resource. With an experienced adviser by their side, Usman remembered the once forgotten idea of opening up an online business to sell used valuables; the online Sunday Bazaar. Farid readily bought into it. They already had an incubation space at IBA and the infrastructure in place to setup another online business. This gave birth to Khazanay.com.

Setting up Khazanay.com

The explosion of online businesses in Pakistan made Usman and Farid to think in the direction of ecommerce. An online store does not have a high fixed cost in shape of rent of premises; therefore, theoretically it can run on thin margins. With clothing, mobile phones, tablets, laptops, toys, cars and even vegetables and groceries available online, the problem was to find what to sell that no one else was selling. During a brainstorming session, Usman remembered the Sunday Bazaar closure and how he would find valuable stuff at a bargain. The more Usman and Farid discussed, the stronger the idea became. Incidentally, Usman was wearing Nike brand that day, which he had bought from Sunday Bazaar a couple of years ago. Soon they were convinced that used branded shoes may have a good market if sold online.

The next step was to find the supply line. Farid's proficiency in Pashto language again came to their assistance, and they found their way from shop to shop, to the distributor, and ultimately to the place that imports used shoes. These shops and suppliers were located in relatively hostile areas of the city, not frequented by regular public. Farid's Pashtun background, and Usman's fair complexion made it easy for them blend in and explore these areas without any problem.

They found that used shoes are imported by different suppliers and sold in the form of "lots" (packs). One lot of about 100 shoes cost about Rs. 100,000, but the price may vary according to the condition. The lot is unsorted; meaning it can have pair of shoes of different sizes and qualities. Shoes are usually very dirty therefore finding a good pair is difficult. A lot usually has 10% excellent quality shoes, 35% good quality shoes, 40% of average quality, and remaining shoes that are below than average quality. The shoes are extremely dirty therefore a regular looker would perceive whole lot to be of dubious quality.

A small survey amongst family and friends assured them that the used shoes, especially the excellent quality ones, would have good market. Therefore, in November 2015, they decided to get into this business. Usman's brother suggested the name of "Khazanay" meaning "treasure" in English language. The concept was that you can find treasure even in scrap.

Being a start-up, the logical way of doing business was to get into a partnership. They started as equal partners with a seed capital of Rs. 1.5 million. The problem of office space was sorted out when someone told them about IBA incubation center. The center charges a nominal rent of Rs. 30,000 per month, and provides office and storage space along with electricity and air-conditioning to start-ups. The added advantage was expert guidance from technology and entrepreneurship experts available at IBA.

The first thing on agenda after setting up office was to develop a website. Few quotations from local software houses obtained earlier ranged between Rs. 2 million to Rs. 4 million. Budgetary constraints forced them to look for alternatives and luckily, within a day or two, they bumped into the next-door start-up at the incubation center by an IBA CS student. The student, about to graduate in a few months, had recently opened shop and quoted Rs. 500,000 for the whole project. This amount was within their budget. The student could drop into their office whenever he was free from his classes, meaning they could review what he was doing and make amendments as the project progressed. Weighing the pros and cons, despite it being the student's first main project, they engaged him to do the work. Apart from technology, the main feature that compels the customers to come to a website is its design, and simplicity of use. Usman's family business was designing and printing. He was well practiced in area of graphics designing that helped him make the graphical design of the online store and a catchy logo; saving a lot of money. The website was completed and became operational on 1st January 2016.

Usman and Farid had to go themselves to procure suitable lots. In January, they bought one lot on cash. Preparing the product for delivery was difficult than they had earlier anticipated. It was really a hard and cumbersome job. Although, the shoes were all branded, but to get them ready to sell they had to wash all of them first. Farid tried his own washing machine at home for the first lot. However, Usman says: "100 pair of shoes hanging from the clothing line to dry up was not a sight fit for the neighbors". Also, Farid recalls: "I got strained arms by working two straight nights on the first lot just rubbing and removing stains from the shoes". After the rub the shoes had to be washed again and dried. They immediately searched and found a launderer who would bring the shoes to an even better condition than what they could pull out after a rub at home at a cost of Rs. 25 per pair. From the second lot, the launderer took care of washing and drying.

Meanwhile work was going on developing the website and problems were cropping up almost on a daily basis. Each item was unique so they had to be uploaded separately. Their plan was to upload 4 to 5 pictures of each item, to ensure that the buyer understands the condition of the good. Getting the pictures uploaded one-by-one would be time consuming, and would fail if sales grow. The system should be flexible enough to cater for the future needs. Getting the upload system to work took some time. The first few instances crashed as soon as number of visitors exceeded ten, meaning that the web-hosting provider did not have adequate RAM. It is

very difficult to estimate visitors to an online store, so the system should be able to take the unexpected load. The solution was a cloud based system that could be scaled up when required. The system was tweaked many times to find out the optimum point where cost-benefit would be favorable. They settled on a configuration that had a monthly cost of \$100, and would cater to approximately 500 simultaneous visitors. The payment is to be made on first day of the month, on prepaid basis.

The shoes had to be sorted into categories “excellent”, “good”, “average”, and “below average”. Both Usman and Farid took considerable time into devising a categorization mechanism. In the first few weeks, they used pure judgment. Farid’s analytical skills came in handy and he came up with an innovative process to determine the quality of each shoe through the tell-tale signs of the wear & tear. Some indicators, among others, to determine the quality of the product include the usage marks on the heels of the shoes, the grains on the shoe sole, the condition of the upper cover and the overall look. All the features are systematically crafted into a decision matrix that when filled provides the quality of the product. Farid also used the extension of this procedure to ascertain the price of each product that catered well to the product’s brand value and overall design. This system was objective, and employees were trained to use it.

After sorting, the next process was to photograph the product. As the shoes were used, it was important to take photographs at the angle that can show the wear & tear clearly. Using Youtube’s videos, a small studio was set-up consisting of a table with white backdrop and two lights. The first lot was photographed by Usman himself, using Farid’s iphone. From February, three employees were hired at Rs. 12,000 each. One was given a digital camera costing Rs. 15,000 and was made the product photographer. One was given responsibility of uploading of product photographs, and maintaining sales order record on MS-excel. The third employee was made responsible for packaging, and dispatching the goods. From start of April, six more employees were hired at Rs. 12,000 each to supplement the three already working. Three teams of three employees were made. One supervisor was also hired at Rs. 15,000 a month on the same day.

Next was marketing the product online. An online store requires constant marketing. Usman and Farid discussed many mediums, but Facebook was chosen because of its reach and ease of marketing. Facebook provides target marketing facility where factors such as area, age and interests could be used to target the marketing efforts. Usman’s designing competence came into use again, and he developed eye-catching advertisements to be run on Facebook. Ordinarily, getting these graphics done from market would cost a ton, but doing it in-house significantly helped their cash flows. The marketing budget approved was \$40 per day for 50 days, and then \$30 per day for 50 days, and then \$10 per day for 100 days in the year 2016.

A Facebook business page was developed to market their product. The only thing left now was to devise a dispatch mechanism. Several courier companies were contacted, but Leopard Couriers was chosen for their relatively cheaper delivery rates, online portal and market reach in main cities of Pakistan. Credit card payments are not popular in Pakistan therefore Cash-on-

Delivery (COD) is the favorite method amongst online stores. Khazanay also decided to use COD.

Courier is a tricky business. Rates are dependent on weight as well as destination. Leopard has divided the country into three zones, A, B and C. Courier charge for zone A is Rs. 150, Rs. 200 for Zone B and Rs. 250 for zone C for a half kg package. Excess weight would be charged as Rs. 50 for each extra half kg. The orders received online throughout the day would be identified, recorded and packed. The courier company will pick all packages in the evening the same day. These packets will be delivered to destinations by the courier company's network. A rider will deliver the packet to the customer, and receive the payment. The courier company insisted that their riders are instructed to take cash before allowing the packet to be opened. Therefore, the customers do not have the option to check the product before making the payment.

If the customer cancels the order, or refuses to pay before inspecting the shoes, the courier rider will take the unopened packet back to his office that will subsequently be sent back to Khazanay. Of course, returning the packet to Khazanay incurs double charge.

Leopard's courier company has an online system where Khazanay can track progress on their deliveries. Every month end, a detailed invoice is to be prepared by the courier company and a cheque of the collections (after deduction of courier company charges) would be given to Khazanay within the first week of next month.

Push to Jump Start Khazanay.com

Using their next door tech start-up for Khazanay's website development turned out to be a boon. Farid and Usman were coming up with innovative ideas that were being incorporated into the website on the go. Usually, a software house restricts their service to a specific number of 'change orders'. Any request for modification above that number increases the cost. As it was a first major job for the software house, they were more than willing to make the website better than anything available in the market.

With everything in place, the entrepreneurs did a soft launch and marketed their product through Facebook and word of mouth. They received a positive response from the market with feedback on how they could better streamline their processes.

With increased sales, storage space was required. Furniture including shelves was bought for Rs. 50,000 in April. Also in April, Laptops and additional mobile phones were bought for Rs. 150,000. All equipment i.e. cameras, mobile phones and laptops are expected to last for three years with negligible scrap value. Furniture is expected to be used for five years. For clarity purposes, an internal control was added that a Khazanay team member would confirm each sales order through phone, and inform the customer that goods are used, and payment is to be made before opening up the package. This control reduced the chances of confusion thereby reducing costs.

Shipments were 20% to zone A, 30% to zone B and 50% to zone C. The bulk of the shipments i.e. 80% were within half kg, with 15% between half and one kg and 5% between one and one and a half kg. Despite best efforts, 5% customers either insisted on opening the package before paying the courier, or refused to acknowledge the product for any other reason, so sales were returned.

In January one lot was purchased on cash. Thereafter, two lots per month have been procured on cash. Starting from July 2016, the supplier has started giving credit to Khazanay. Payment is now required to be made before 5th of the next month. The average selling price of an excellent quality pair of shoe is Rs. 3,000, Rs. 2,500 of good quality, and Rs. 2,000 of average quality. Repeated attempts were made to sell shoes of less than average quality but they are piling up in the store. Farid thinks that these may have to be scraped someday.

The positive market response and expansion brought with it the challenge of getting their accounts set right to better understand the business situation. Usman and Farid are now looking for a consultant who can prepare financial statements for the year ended 31 December 2016. They estimate that miscellaneous expenses including packaging material, traveling and other costs, and monthly staff lunch throughout the year will be about Rs. 75,000. All the shoes in inventory, except 'below average quality', are to be sold till 31 December 2016. The next lot will be received on 1st January 2017, as imports are delayed due to Christmas and other holidays in USA and Europe. The invoice received from the courier company on 31 December 2016 are expected to show the total collections receivable by Khazanay of Rs. 395,000 for the month, and courier charges of Rs. 47,775 payable to courier company.

Both, Usman and Farid, have not drawn from their business. They suspect that they have paid some money from their pocket into the business that is unaccounted for. They have agreed that if this is the case, the amount will be treated as loan. For ease of accounting \$1 is to be treated as Rs. 105.