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About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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THE IMPORTANCE OF FINANCIAL INFORMATION IN RUNNING A BUSINESS

by Mary Hanson

Financial information and analysis is more important than ever. Business owners who are not using their financial information and preparing financial projections based on actual results as the basis for planning and decision-making are not managing their businesses as capably as they should. Effective use of financial information is essential in the current economic environment.

The financial statements of a business are a business blueprint, a scorecard, and a lie detector test all in one. How is your business really doing?

Every business owner and manager needs to be skilled not only in reading financial statements to see how the business is doing, but also in using the financial information as a guide in business decision-making.

Both the current economic environment and business trends make effective financial management a necessity. Financial information can no longer be something the bookkeeper or accountant generates and the business owner expects someone else to read. A business owner has to be using financial statements and other current financial information on the business as a key tool in planning and decision-making.

For the New Business

Since business has become more challenging for established businesses, we know that getting a new business off the ground has to be even more

challenging. Well supported financial projections are even more crucial than they were in the past. With the exception of non-profits, the reason for starting any business is the expectation that the business will “make money.” For a large business with investors, this means generating enough profit to return funds to the shareholders as a return on investment and a reason for putting their money at risk. For many small businesses, the objective is to have a job that pays better than alternatives in employment. The business must be financially successful enough to pay the business owner good compensation for his or her services and a return on investment on the funds invested to start the business.

A proposed new business must have a business plan and financial projections that strongly support the expectation that the business will meet the new business owner’s financial objectives. Before spending time and money on actually starting the business, a detailed and well-founded financial plan should provide persuasive and credible explanation of how and why the proposed business will be profitable enough to satisfy the obligations of the business and the expectations for a return on investment. A new proposed business plan has to show:

- A level of revenues that makes sense based on the type of goods or services to be sold, and the market for those goods and services. Even if the services or product are likely

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to be in demand and to sell in high volumes, the projections have to take into account that it can take a very long time to get a new business established and get the volume of sales up to the necessary levels.

- A profit margin on the goods and services that makes sense with the volume of sales that can reasonably be expected. One of the key problems for a small business is that it cannot easily compete on price. While a large national business can be very successful with a small markup on goods or services, a small business often needs a very large markup in order to make a lot of profit on its relatively limited sales. The challenge is greatest for a small business that consists of one store or one office. That one location then has to generate enough profit to cover all the overhead of the business, pay the owner adequate compensation for the owner's services, and provide a return on investment to the owner. In the current economy those basic goals often cannot be met.
- Sources of additional funding to cover shortfalls until the business gets established. If there are no additional funds available to support the business, it is not logical to start the business. Every business plan needs to include a range of results, from better than expected to far worse than expected, and needs to include funding and steps to be taken that address the different scenarios. If business projections show a likelihood of needing additional funds, the source of those funds must be identified. If a credible plan for obtaining additional funds

(and repaying those funds) cannot be identified, the business plan should not be implemented.

For the Existing Business

The existing business has the benefit of actual financial results, not just projections based on averages and expectations. Even if financial results are poor, they are valuable as “the truth” of how successful a business is and what the real challenges are. The business owner needs to know:

- What are the current levels of gross revenues? What did the business bring in last year? Are gross revenues higher or lower this year than they were last year? You need to be aware of your level of sales and whether total revenues are going up or down.
- What is the profit margin as a percent of goods or services sold? If you buy widgets from your supplier for \$100 each, are you able to sell them for \$200 (for a 50% profit margin)?
- Are your profit margins stable or are they dropping? (Do you have to sell your widgets for \$150 instead of \$200 in order to avoid losing business to your cheaper competitors or to maintain your volume of sales?) If your profit margins continue to drop, you need to understand that at some point the business will no longer be making money.
- What is your core basic overhead each month? You need to know how much you have to bring in in profit each month (after payment for the goods or services that were sold) in order to cover the average month's bills. If you have run up debt, you need to include monthly

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payments on the debt as part of what you have to cover each month. Included in the overhead number will be the amount you need to take home to cover your personal bills. If a business is unable to cover ALL regular expenses that are needed to carry on in business, in addition to the cost of the goods or services sold, the business is going negative, either running up debt or stretching out the time for payment of bills or making purchases. Failing to recognize shortcomings in a business just kicks the issue down the road to be dealt with at a future date when the lack of funds is more obvious. By examining financial statements and cross-checking numbers, the real condition of the business can be assessed, hopefully in time to make changes and get the business back on track.

- Are you current on all your bills (e.g., paying accounts receivable in 30 days)? Are you getting slower in your payment of bills? Is your slower payment of bills masking the reality that your revenues are inadequate?
- What is the level of funds in your bank account? Is this lower or higher than it used to be? Has your use of available funds obscured the reality that cash flow is inadequate?
- What is your current level of debt? Are you increasing your debt or paying it off? Do you have a credible plan for paying it off? If your debt is increasing each month, do you know why? Do you have a plan to improve business profits to pay off the debt?
- How will your business look three years from now if your financial

situation continues as it is? Is your business getting better or getting worse?

- What are your long term plans? Do you plan to sell the business, merge with another business, or bring in investors? Do you know how your business will be viewed by potential buyers, other businesses or investors? Are you developing the business in a way that makes the business attractive to those potential business partners?

How to Look at Your Business

Businesses that are attractive to buyers are those with attractive profit margins. A healthy profit margin means that the business can provide a good return on investment to an investor or purchaser. A healthy profit margin means that a business can be grown to a larger business by using the profits as a source of funding for growth.

A business that is barely breaking even is not very attractive for the opposite reasons. There is little reward for anyone stepping into the shoes of the owner. And the business would need additional funds contributed from outside in order to make improvements, implement new business plans, or promote a higher level of sales.

If a business is doing so poorly that a new marketing campaign or small changes will not turn it around, a business owner has pretty much three alternatives. One is to make a whole-hearted commitment to make the changes necessary to resuscitate the business and bring it to profitability. A second approach is to adopt a new business plan and transform the

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Publisher's Note

In the past two years I have seen many businesses seriously challenged by the economic downturn and by other changes in the business environment. Businesses have faced drastic drops in revenues, competition from cheaper on-line competitors, drops in consumer spending, lawsuits by employees and customers, termination of contracts, drastic changes in tariffs, drastic changes in product testing requirements, and shifts in entire industries.

The businesses that DON'T have a good handle on their financial information and the financial blueprint of the business are seriously disadvantaged in making the big decisions necessary to survive changes imposed by circumstances.

Many businesses became unprofitable in the past two years and many made changes to survive and return to profitability. I have seen a disturbing number of businesses in which the owners were unaware of the levels of losses being incurred.

Business owners need to maintain, or to gain, financial literacy to survive in the business world today.

Mary Hanson
Attorney/Publisher

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business into a different business. The first and second approaches usually require a commitment to outside consulting from experts who can recommend major changes in goods and services, markets, marketing, staffing, advertising, distribution channels, and other aspects of the business. Many small businesses cannot afford the services or the implementation of large-scale changes. Many are unwilling to face such extreme changes.

If changes cannot be made the third alternative is the sale of the business. The buyer of the business cannot be an employee or individual who would attempt to run the business in its current unprofitable mode. If the current business structure is unprofitable for you, the same structure will be unprofitable for a buyer attempting to operate it in the

same manner. The right buyer needs to be willing and able to make changes (along the lines of the two alternative approaches above), or the buyer needs to be a competitor or someone in the same business who is well-positioned to solve the unprofitability problem by bringing the business into its existing infrastructure. A competitor should be able to get rid of much of the unprofitable business's overhead, hopefully keeping the gross revenues and the profit margins, but avoiding the overhead that made the business unprofitable.

Whatever a business owner chooses to do, being a responsible business owner means being aware of what is really happening with the business and what the consequences of actions or inaction are. Studious attention to financial information is essential in the current environment. **BA**

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