MSU COLLEGE OF LAW

SMALL BUSINESS & NONPROFIT CLINIC

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December 4, 2008

"The Importance of Financial Planning for Small Businesses"

Without thoughtful financial planning, even the most promising small business start-up will struggle to succeed. How you structure your business' finances impacts the type of funding available to establish, maintain, and expand your business. In turn, funding determines the resources you can afford for your business, such as staffing, equipment, and marketing.

Here are eight important things every small business owner should consider to create a sound financial plan.

1. **Realistic Revenue and Expense Projections**
   - ***Do not let your optimism cloud your judgment.*** Entrepreneurs are by nature optimistic about the future financial success of their new business. Challenge yourself to evaluate the practices, success, and failure of competing businesses in your market to accurately project revenues and your break-even point. Be prepared for a 12- to 18-month startup period during which you will be unable to draw cash out of the business. Plan for what happens in both best-case and worst-case scenarios.

2. **Funding Reserves**
   - ***Cash reserve:*** Once you realistically project revenues and expenses, set aside enough cash to cover daily operations during your first 12 to 18 months of business, or until you will turn a profit.
   - ***Line of credit:*** A line of credit is a loan you can access as needed to meet unexpected financial obligations of your business.
   - ***Other funding sources:*** Many state development agencies offer direct small business grants and other types of financial assistance designed to encourage and assist entrepreneurs in starting or expanding a small business. The Michigan Economic Development corporation is a good place to start: http://www.michiganadvantage.org/.
     In addition, the U.S. Small Business Administration lists links to financial resources, including grants, through its website:
     http://www.sba.gov/smallbusinessplanner/start/financestartup/index.html.
     Also see the online resource, "For Profit Funding Resources," at
     http://www.law.msu.edu/clinics/sbnp/publications/ForProfitFunding.pdf for more information.

3. **Planning for Departure or Addition of Owners**
   - ***Buy-sell agreements:*** These are contractual provisions that spell out the terms governing adding new owners to the business and how existing owners may withdraw from the business. Parameters for valuation of each owner's interest, restrictions on sales of shares to third parties,

and obligations of the company to purchase departing owners' shares are spelled out in the buy-sell agreement, thereby preventing the need to make these determinations at the time there is a change in ownership of the business. These terms may be included in the operating agreement of a limited liability company or the bylaws of a corporation; a separate contract is not required.

4. <u>Develop a Strong Business Relationship with Your Banker</u>

- ***A banker who knows you and understands your business:*** Your banker can best advise you about the financial tools available to you through his/her institution, such as:
    - ***An interest-bearing business checking account with online access:*** You can check your accounts daily regardless of whether you are in the office. Know the status of cash flow between bank statements.
    - ***Business line of credit:*** This flexible source of funding requires payments only over the period of time in which your business carries a balance.
    - ***Loans:*** Small business loans provide financing for fixed asset purchases and other planned large business expansions and improvements.
    - ***Investment products:*** As your business and profits grow, your banker can suggest ways to maximize your return on profits through investments that match your risk level and investment amount.

5. <u>Accurate Record-keeping and Regular Monitoring of Financial Status</u>

- ***A reliable, experienced bookkeeper:*** Accurate records depend upon accurate record entry. Hire a bookkeeper who understands accounting practices for your particular type of business.
- ***Financial management software:*** Bookkeeping software offers accuracy and reporting advantages unavailable through standard spreadsheet programs. Programs such as QuickBooks by Intuit® can be purchased for less than $200 and provide a user-friendly way to track specific data relevant to your business' finances.
- ***Monthly bank reconciliation:*** When your monthly bank statements arrive, be certain your bookkeeper takes the time to reconcile them with your internal accounting records. Any discrepancies should be addressed immediately. Personally review your financials on a monthly basis, at minimum.
- ***Gain an understanding of basic financial statements:*** Knowing the contents and purpose of a balance sheet, an income statement, and a cash flow statement puts you ahead of the game in knowing the exact financial status of your business. Lenders look to these key financial statements when considering your business' fitness for a loan.

6. <u>Consult a Tax Professional</u>

- ***Have your taxes done by a tax professional:*** A professional tax advisor can show you ways to maximize write-offs legally and address issues such as employment taxes as your business grows. He/she will also be available to assist in the event your business tax return is audited by the Internal Revenue Service.

7. <u>Obtain Business-related Insurance</u>

- ***Business liability insurance:*** Business liability insurance protects your small business in the event of a lawsuit for personal injury or property damages. It will usually cover the damages from a lawsuit along with the legal costs. Depending on your business needs, liability insurance can be purchased in many forms. Even if you own a limited liability company (LLC) or an incorporated company, you can be personally liable if you:
    - Provide a personal guarantee for a loan
    - Personally injure someone
    - Acted in an irresponsible or illegal manner
- ***Key employee insurance:*** Small businesses can be heavily impacted by the departure of a key employee. One employee's vendor connections, management skills, or sales ability can be the key to keeping the business going. Key employee insurance protects your business against the loss of such an employee. If you are applying for a business loan, your banker may require

this insurance as security in the event the key employee becomes incapacitated during the life of the loan.
- ***Other types of insurance may apply to your business.*** Your insurance advisor can make product recommendations based on the specific insurance needs of your business.

8. **Determine Pricing Formulas and Policies**
   - ***Set a marketable profit margin:*** Pricing your products or services out of the market, either on the high end or low end, results in weak financial performance. Regularly evaluate your competitor's pricing structure and negotiate with suppliers to keep overhead down. Adjust your cost estimates to account for market fluctuations, and create a workable profit margin that can absorb a reasonable amount of change in overhead.

The success of your new business requires thoughtful, realistic planning and building relationships with professionals to support your business plan. Take time to address these basic business needs from the outset to prevent avoidable issues in the future.