RISK ASSESSMENT FOR SMALL BUSINESS

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Introduction

For anyone who dreams about starting a business, buying an existing business or is the owner of a business, one of the key determinants in making decisions is "risk". Risk factors associated with the particular business venture must be researched in order to have a reasonable chance of success:

The purpose of this counseling tool is to help potential or existing business owners think about some of the risk factors that are important to the well being of their business.

Risk *is defined as the chance of suffering or encountering harm or loss.*

Risk Assessment Tools

Loan Financing, Understanding the lender's point of view

In most business startups, purchases or expansions, loan financing is a major source of funding required to take the business idea from the concept stage to the implementation stage. When one borrows money, there is a certain amount of risk assumed by the Borrower and the Lender. It is important to have knowledge about what a lender needs to know about your business proposition prior to applying for the loan. The following information is intended to help you be prepared for what you need to know in order to "Get The Loan".

Questions your banker will probably ask:

1. Can the business repay the loan? (is cash flow greater than debt service?)
2. Can you repay the loan if the business fails? (is collateral sufficient to repay the loan?)
3. Does the business collect its bills?
4. Does the business control its inventory?
5. Does the business pay its bills?
6. Are the officers committed to the business?
7. Does the business have a profitable operating history?
8. Does the business match its sources and uses of funds?
9. Are sales growing?
10. Does the business control expenses?
11. Are profits increasing as a percentage of sales?
12. Is there any discretionary cash flow?
13. What is the future of the industry?
14. Who is your competition and what are their strengths and weaknesses?

The following factors indicate the "ideal" situation for going to a bank for a small business loan. If you cannot respond "yes" to all of these factors, it does not mean that you cannot obtain financing. Lenders look at these factors in the aggregate. In other words, if you are weak with respect to one factor but strong in another, your overall situation may allow you to obtain a loan.

Applicant Factors

1. Credit: excellent ratings and no personal or business bankruptcy.
2. Arrest: no arrest for fraud, theft, embezzlement, or drug/alcohol abuse.
3. Cash: applicant has 20% or more of cash needed for the project.
4. Net Worth: applicant has net worth (for use as collateral) greater than 100% of the loan amount.
5. Income: applicant does not need to draw income from the project for a period of time. Fixed payments per month (house, car, credit cards) do not exceed 40% of net income. (A working spouse who can cover living

expenses is highly desirable. Must provide three years of tax returns to verify income and standard of living.)

6. Experience: applicant has three to five years general management experience as a minimum, and, preferably, one or more years industry specific experience.

<u>Business Factors</u>

Buying an existing business:

a. Profitability - must have good track verified by 3 years financials and tax returns.
b. Gross Sales – must be healthy.
c. Asking Price -- should have a thorough valuation, including appraisals.
d. Market Position -- should have a good market position.
e. Financial Ratios -- should compare favorably to industry standards.

Starting a new business:

a. Market-- must have a thorough market analysis.
b. Location -- must be a clearly good location.
c. Experience -- applicant must have excellent experience.

Expanding a business:

a. Profitability – must have a good track record.
b. Cash Injection – should have at least 10% cash needed.
c. Financial Ratios -- better than industry standards

Self-Assessment Tool – Financial

Whether you are applying for a micro loan, Small Business Loan or a traditional bank loan, there are certain factors that improve your ability to obtain financing. The following is a simple checklist to do before you begin to seek capital.

Do you have a good personal credit history?

Research indicates that good personal credit history is one of the most important factors in identifying borrowers that will repay their commercial loans. Many loan programs require perfect personal credit in order to qualify.

Have you filed all income tax returns?

Lenders and government loan programs alike want to see that an individual has met their tax obligations for both filing and paying taxes.

Does the business have the ability to repay a loan?

(For existing businesses) If the business is profitable, then there are demonstrated profits to repay some amount of new debt. If a business is not profitable, then it becomes very important to prove how it will be profitable in the near future so that a loan can be repaid.

(For start-up businesses) It is very important that you find as much data on comparable businesses or industry statistics in order to "prove' the revenues you intend to generate and the expenses you anticipate incurring.

Does your business have a positive net worth?

(For existing businesses) The net worth of the business should be positive. If there are loans from shareholders on the balance sheet and you are able to subordinate these (not pay the shareholders) while you pay the bank loan back, you may consider these loans from shareholders as equity.

Is your business carrying too much debt?

(For existing businesses) Businesses that have too much debt will find that their profits are directed at paying back loans and not building retained earnings in the business that can fund future growth. Consequently, banks and government loan programs look more favorably at loan requests that do not add too much debt to the business. Banks often look for a debt to net worth ratio of 4 or less (total liabilities divided by equity).

Do you have enough of your own money in the business?
(For start-up businesses) All loan programs require that the business owner put their own money in the business. This owner equity injection shows that the owner believes in the business enough to risk his or her own money. Some programs may require only 10%

owner equity; other programs could require at least 30% and will look more favorably on a loan request the more equity is in the business.

Do you have collateral to secure a business loan?

Business and personal assets can be considered collateral, or a way to repay the loan if the business defaults on a loan. Most collateral is valued at an amount less than face value based on a variety of factors.

Are you willing to personally guarantee a loan?

Most business owners are asked for a personal guarantee in order to obtain their first business loans.

Do you have experience in running your own business?

(For start-up businesses) For a new business especially, it is important for the business owner to demonstrate that he or she has experience in the industry and/or entrepreneurial experience. If you have never owned or operated a small business before, we strongly recommend that you attend entrepreneurial training classes.

If you are having difficulty answering these self- assessment questions, then obtaining loan financing may be difficult. A small business counselor can discuss these issues with you and perhaps help improve your chances for obtaining financing by suggesting alternative ideas or concepts.

Ratio Analysis

If you monitor the ratios on a regular basis you'll gain insight into how effectively you are managing your business. Here are a few financial ratios that may help in assessing how your business is doing and in turn determining financial risks that need to be addressed.

LIQUIDITY. Financial ratios in this category measure the company's capacity to pay its debts as they come due.

Current Ratio

Definition: The ratio between all current assets and all current liabilities; another way of expressing liquidity.

Formula: $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Analysis:
- 1:1 current ratio means; the company has $1.00 in current assets to cover each $1.00 in current liabilities. Look for a current ratio above 1:1 and as close to 2:1 as possible.
- One problem with the current ratio is that it ignores timing of cash received and paid out. For example, if all the bills are due this week, and inventory is the only current asset, but won't be sold until the end of the month, the current ratio tells very little about the company's ability to survive.

Quick Ratio

Definition: The ratio between all assets quickly convertible into cash and all current liabilities. Specifically excludes inventory.

Formula: $\frac{\text{Cash + Accounts Receivable}}{\text{Current Liabilities}}$

Analysis:
- Indicates the extent to which you could pay current liabilities without relying on the sale of inventory -- how quickly you can pay your bills. Generally, a ratio of 1:1 is good and indicates you don't have to rely on the sale of inventory to pay the bills.
- Although a little better than the Current ratio, the Quick ratio still ignores timing of receipts and payments.

SAFETY. Indicator of the businesses' vulnerability to risk. These ratios are often used by creditors to determine the ability of the business to repay loans.

Debt to Equity

Definition: Shows the ratio between capital invested by the owners and the funds provided by lenders.

Formula: $\frac{\text{Debt}}{\text{Equity}}$

Analysis:
- Comparison of how much of the business was financed through debt and how much was financed through equity. For this calculation it is common practice to include loans from owners in equity rather than in debt.
- The higher the ratio, the greater the risk to a present or future creditor.
- Look for a debt to equity ratio in the range of 1:1 to 4:1
- Most lenders have credit guidelines and limits for the debt to equity ratio (2:1 is a commonly used limit for small business loans).
- Too much debt can put your business at risk... but too little debt may mean you are not realizing the full potential of your business - and may actually hurt your overall profitability.

Debt coverage ratio

Definition: Indicates how well your cash flow covers debt and the capacity of the business to take on additional debt.

Formula: $\frac{\text{Net Profit + Non-cash expenses}}{\text{Debt}}$

Analysis:
- Shows how much of your cash profits are available to repay debt.
- Lenders look at this ratio to determine if there is adequate cash to make loan payments.
- Most lenders also have limits for the debt coverage ratio.

<u>PROFITABILITY</u>. The ratios in this section measure the ability of the business to make a profit.

Sales Growth

Definition: Percentage increase (or decrease) in sales between two time periods.

Formula: $\frac{\text{Current Year's sales - Last Year's sales}}{\text{Last Year's sales}}$

Note: substitute sales for a month or quarter for a shorter-term trend.

Analysis:
- Look for a steady increase in sales.
- If overall costs and inflation are on the rise, then you should watch for a related increase in your sales... if not, then this is an indicator that your Prices are not keeping up with your costs.

Gross Profit Margin

Definition: Indicator of how much profit is earned on your products without consideration of selling and administration costs.

Formula: $\frac{\text{Gross Profit}}{\text{Total Sales}}$

where Gross Profit = Sales less Cost of Goods Sold

Analysis:
- Compare to other businesses in the same industry to see if your business is operating as profitably as it should be.
- Look at the trend from month to month. Is it staying the same? Improving? Deteriorating?
- Is there enough gross profit in the business to cover your operating costs?
- Is there a positive gross margin on all your products?

Net Profit Margin

Definition: Shows how much profit comes from every dollar of sales.

Formula: $\frac{\text{Net Profit}}{\text{Total Sales}}$

Analysis:
- Compare to other businesses in the same industry to see if your business is operating as profitably as it should be.
- Look at the trend from month to month. Is it staying the same? Improving? Deteriorating?
- Are you generating enough sales to leave an acceptable profit?

Commitment/Management

Entering into business obviously has financial risks that one must be aware of, however one must also consider the personal risks that are possible. Once you have concluded that you have what it takes to successfully operate the new venture, you must decide if business ownership is the right choice for yourself and your family. There is no question about it business startup is difficult. You can be sure you are required to put in long hours and must deal with uncertainty and stress during the initial and often subsequent stages of starting a new business.

Starting a new business usually means you must deal with the fact that there is no certainty. There are no guarantees of longevity, paychecks, or leisure time. One must be aware of the major commitment required to start and operate a business.

To evaluate you readiness for business startup, consider the following:

1) Are you aware of the total impact starting a new business will have on your family and friends?

2) Are you prepared to make sacrifices for the new business? Are you ready to give up vacation time, change your present lifestyle, or commit personal assets to secure the business?
3) Can you handle the insecurities associated with starting a new business?

Industry

One must consider the industry his or her business fits into to determine where they fit, how they fit, and what risks factors are associated with that industry. A businessperson should be aware of and be prepared to answer the following industry risk analysis questions.

1) To what degree is the industry affected by economic cycles?
2) What political risks may affect the industry?
3) Are there technology risks that may affect the industry?
4) How predictable are earnings?
5) What are the major cost factors in the industry? (Raw material, labour, capital, etc)
6) Where is the company's product in the product life cycle?
7) Is the industry fragmented or dominated by a few large companies?
8) What are the barriers to entry into the industry?
9) How dependent is the company on suppliers?
10) Is the industry cyclical or seasonal?
11) What condition is the industry in?

Insurance

In today's society, insurance is a major issue. Each year it seems that more and more lawsuits are occurring, many of which would never have been considered in the past. A small business owner must be aware of the risk of being sued, and therefore should have an insurance policy in place to protect himself and his business. The best advice is to speak with a few insurance agents as part of your business planning to determine a policy that best covers the needs of your specific business.

Conclusion

Being in business is not for everyone. There are so many factors to be considered when deciding what is the right decision for you. I hope this tool has been thought provoking in terms of raising your awareness of some of the risks associated with getting in to business. For people thinking about starting, purchasing, or expanding a business, I recommend visiting you local business development officer or small business counselor for advice and guidance.