



## **FROM A LOCAL SHOP TO A GLOBAL CONGLOMERATE**



### **Does Your Business Benefit You?**

What drives some of us to create a business? It takes a lot of work, usually more than being someone's employee, and there is no guarantee of success. You may be driven by the compulsion to be independent, or perhaps by an idea that just won't let go. Maybe you feel you are "unemployable" in any meaningful sense. The psychological forces that drive us can be complex and little understood, especially to the one driven by them. Another time, perhaps, we can explore the reasons why we make the choices we do with the hope of learning how to make better choices more often than poor ones. Ultimately, we make choices that we think will benefit us more than the alternatives. This is the essence of capitalism: pursuing your self-interest through choices made within the legal framework of society and in so doing benefiting the society as a whole with the help of Adam Smith's "invisible hand".

Starting and running a business requires one to make choices non-stop. Typically, the business owner focuses on the choices required to decide the direction of the enterprise and its day-to-day operation. Often neglected are the choices along that way that can make a profound difference in how you, the owner, maximize the benefits of investing your heart and soul. Today I will address some of the benefits of business ownership.

### **Money, Prestige, Satisfaction, Independence, Exit Strategies**

Did I mention money? There exist other reasons to work, but they are not the focus of our article today. I am assuming you are willing to work because you wish to make money for yourself, your family, your dreams, your progeny, your whatever. Perhaps because of your interest in and experience with "widgets", you have decided that owning a widget-working business is the obvious way for you to achieve these goals and so you decide to start Vanya's Widget Works. If you are like most people of an entrepreneurial bent, you will just plunge right in and start working those widgets. So long as you have money in your bank account beyond the bills you must pay, you think you are succeeding. Well, you may or may not be. After all, success means different things at different times and to different people.

Just as in Shakespeare's *Ages of Man*, businesses have a life-cycle too. The "infant" is the envisioning stage, when the idea first enters your head. You can't start a business without imagining yourself doing it. There is no business at this stage, so there is no tangible benefit to you, or anyone else. You are still dreaming.

If you wake from the dream and begin to take action, you are taking your first step towards business success. You will have entered the planning stage, however rudimentary. For many would-be entrepreneurs this stage is akin to:

“...the whiling schoolboy with his satchel  
And shining morning face, creeping like snail  
Unwillingly to school.”<sup>1</sup>

Yet this “homework” will often make the difference between success and failure of an enterprise. Even if you don’t have a formal business plan with financial projections based on extensive market research, you must have at least realized you need that widget polisher and a storefront to sell from. It may have been written on a napkin, but you have a plan. Otherwise you never get to the next stage and you are no closer to reaping the benefits.

Let’s say you had the idea last night and wrote your plan on a napkin you stuffed into a pocket. It’s morning now and you find the napkin and realize it wasn’t a dream and that, *yes!*, you will make this work! Now begins the start-up phase. You excitedly run off to enlist friends and family into helping you with your venture, collect your widget working tools, apply for all the necessary permits and licenses, start negotiating a lease for your facility, and etc. After all, you had already read Alexander Aginsky’s article on how to finance your business and you know you are on the right path, however, there is one thing you are likely to be overlooking: your exit strategy...

### **Begin with the End in Mind**

That’s my first principle of business. Someday you will leave your business and the best time to begin planning for that transition is at the start. One measure of success is your ability to leave your business under the most favorable conditions for you. How do you determine when and what is favorable? It helps to know the value of what you have.

The value of a business is often in the eye of the beholder. Vanya’s balance sheet may tell him his assets far outweigh his liabilities, but is that inventory of widgets and widget-making machines worth very much without Vanya’s knowledge, drive and commitment? Perhaps. It depends on how easily a stranger can slip into Vanya’s shoes. If the shoes are very hard to fit, that may leave only the option of an auction of the tangible assets. Sadly, the liquidation value of a business is usually far less than its value as a going concern with positive cash flow.

Obviously, your exit strategy will depend on the type of business you are starting, how dependent its existence is on you, its likely growth trajectory and numerous other factors. Let’s compare two scenarios for Vanya’s Widget Works. We will assume Vanya is one-hundred percent owner of this private corporation. In the first case, Vanya builds a business with capable managers, documented processes, and established customers. The second, more common scenario has Vanya haphazardly building his business with workers that largely follow his direction, with customers that purchase based on their relationship with Vanya, and business processes that reside mostly in Vanya’s head.

Well, Vanya No. 1 has done an enviable job. He can easily step away and let another steer the ship. Control could easily pass to the next generation or someone outside. Based on his financial statements and history he could sell his shares for multiples of his annual cash flow. He may even be able to command a higher price if he has built-up enough “good will” or a commanding position

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<sup>1</sup> William Shakespeare, “Ages of Man”.

in his market niche. Even if the terms of the sale have the new owner paying Vanya out of ongoing operations, there is a strong likelihood that the operation will actually *be* ongoing.

Vanya No. 2 has quite a challenge to face. Who will replace him? The value of the business is largely embodied within him. He never bothered to groom a capable replacement either out of neglect or his not wanting to give up any control. He may have children who would like to inherit his business, but if he hasn't planned for that there is the likely possibility of a fight over diminishing returns. Nobody outside would buy his business on terms as favorable as Vanya No. 1 received and it is not clear that there would be future operations strong enough to guarantee extended purchase payments for long. Vanya will likely end-up liquidating the business assets and walking away with not much to show for a lifetime of work, or he may never leave and "die with his boots on," potentially creating a mess involving the IRS, death taxes and unhappy heirs.

This example is an oversimplification, but gives you a glimpse into a complex world. The lesson is that proper planning can save you enormous grief; let alone save you a good deal of money. The planning needed varies with the type of business, your goals, how it grows, etc. Some of the choices you should consider:

- How to choose the best organizational form for your business and make sure it is structured to provide options for your eventual exit strategy.
- If you have partners and/or investors, you will need to have clearly defined agreements in place for what their roles are in the business and how their leaving will be handled. Would you rather suddenly have to work with a deceased partner's clueless spouse, or have the business pay for insurance to fund buy/sell agreements?
- If you have more than one child, you need to determine if any of them actually want to take over control someday (and whether they have the ability to, as well). The other children need to be given something compensating for the value given the one. In a small business, it almost never works to have siblings as passive "investors" in the business.

### **Always Check the Latest Tax Rules**

Here's some good news: the US government wants to help you get started in business! Have you heard of the American Jobs Creation Act of 2004? If you have incurred start-up expenses after October 22, 2004 from a new business you have started or acquired, you may be entitled to a one-time boost in first-year deductions of up to \$5,000 of qualified start-up expenses. Start-up expenses are costs that would normally be deducted as business expenses by an ongoing operation. For instance, these expenses include:

- ✚ Market surveys
- ✚ Feasibility studies
- ✚ Advertising
- ✚ Salaries and wages to train employees
- ✚ Travel and related costs to secure prospective distributors, suppliers and customers
- ✚ Payments to executives or consultants for professional services

This is a use-it-or-lose-it proposition. If you neglect to use this deduction by the tax return due date these expenses must be capitalized. (This is bad because then you won't benefit from these costs until you sell the business.) And if you decide not to start the business, these investigational costs are generally treated as nondeductible personal expenses. Expenses over \$5,000 must be amortized over 180 months and this write-off is reduced on a dollar-for-dollar basis for start-up expenses over \$50,000. These new rules generally benefit small-business owners who can keep start-up costs to a minimum. Larger ventures, however, will be at a tax disadvantage. Instead of the previous five-year period, it will take 15 years to recover the full amount of start-up expenses.

### **Every Day in Every Way Your Business Gets Better**

Once you have established your business and as day by day it is becoming more of a success, you can begin to secure your benefits. No need to feel guilty about any of this; everyone wants you to succeed. The government has created special rules to follow which can be very favorable for you (if you know about them and how to put them to use). It does so because it recognizes that small business is a major driver of the economy and, hence, tax receipts. The government also hopes you will employ people and that they will pay taxes. Your customers want you to succeed because you provide a valuable service or product that they like; else they would not be customers. They know you won't continue to serve them the way you do if it's not worth your time and effort. It's a win/win/win all around!

The most obvious benefit of owning a business is when it's time for your salary review you usually have that meeting with yourself. That doesn't mean you won't have to document and justify what you decide. Remember, the Internal Revenue Service is your partner in such matters and you need to follow certain standards depending on your organizational form and your industry. Where this can get a little complicated is when you own a corporation and you have two general forms of compensation: salary and dividends. In many cases taking your profits as dividends results in lower levels of employment and income tax liability. This can be a good thing, but if you overdo it and don't take what the IRS considers enough salary for the type of position (CEO?) then they can ask you to recharacterize the payments you received after the fact. And we all know that planning after the fact doesn't work very well.

You will have many choices and trade-offs to decide depending on your particular circumstances. The rules of the game frequently change and what you were content to do in the past may suddenly become unavailable or suboptimal. My advice is not to skimp on advice. Find yourself some trustworthy advisors/consultants who specialize in working with businesses like yours to guide you through the maze of options. Choose professionals who can explain their advice in language you understand. Don't be intimidated. Remember, you are their customer and you should expect your counselors to be as devoted to you as you are to your customers.

### **Home is Where the Office is**

One of the many benefits of being an independent business owner is that you can choose to work from home. The commute is easy and the dress code is whatever you want it to be. These days, if you have a computer, a broadband Internet connection and a phone you can do most anything you need to from home and you can feather your nest some while you are at it. If you own a corporation you can simply have it rent your home office for you, creating an expense for the company and passive income for you. Be sure to research and document that the rental price is fair market value for what you are getting and draw up a proper rental agreement for your records. And you need to show that you actually have an office and are using it.

If you are a sole proprietor you can't rent from yourself, but you can expense your home office for income tax purposes on your Schedule C. Documentation is always an essential part of the game. Measure the square footage of the portion of your home you are devoting to business and divide that by the total area of the home to get a percentage. You are then allowed to deduct that percentage of your rent or mortgage payment and your utilities. There are some complications that arise from this, especially if you will be selling the home someday, but it's a sweet deal nonetheless. As with all of the strategies I am mentioning, always check with your tax advisor before committing yourself to any course of action.

### **Deduct Your Wanderlust**

Almost every successful business I can think of benefits from the owner getting out and about to meet with customers, colleagues, and vendors. Business is ultimately about people after all. You might as well get into the habit of keeping a business diary while you are at it. Contemporary records are the acme of documentation. A typical entry might be:

Business lunch with Customer Alpha at the City Club. \$57.00. Discussed adding X to his standing order of Y. Starting odometer at 33,083, ending 33,155. Parking \$7.00.

Keep the receipts even if they are smaller than is required: it looks good. It is perfectly acceptable to scribble a note on the lunch receipt and to keep a mileage log in your car. You don't have to carry a fancy leather-bound diary with you everywhere. But do keep something. At the 2005 rate of 40.5 cents per mile your mileage deduction can add up fast. Sadly, the IRS will only subsidize 50% of your business meal. As a sole proprietor you would deduct these expenses, whereas a corporation could reimburse you in full, even for the meal, although it can't actually deduct the full amount on its taxes either.

### **Wait! There's More!**

Actually there's much, much more. Sadly, there is no way for me to fit it all in here. You could read a shelf of books, or you could take my advice and retain some good advisors. The best business advisors, I feel, are those who, like you, are entrepreneurial and motivated to help. Are they willing to come to you, ask questions to discover what is truly important to you and research your unique needs? Don't settle for "canned" solutions or someone who may know all the answers but is unable to explain them to you. You deserve better.

Your personal business consultant.

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