The Entrepreneur's
Classic Guide
to Starting a
Small Business

HOW to RUN A SMALL BUSINESS

J. K. LASSER TAX INSTITUTE

5th Edition

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ENTERING THE BUSINESS WORLD

We constantly make economic and financial decisions which affect our lives, and we must live with the consequences of these decisions. However, too often we make our decisions on whim or after a superficial appraisal. We can usually survive such decisions when they involve the purchase of, say, a car. We can buy and drive it without knowing what makes it run; it will operate without our knowledge of its inner workings. We cannot afford, however, to adopt a casual attitude about buying or starting up a business. We dare not be ignorant in this matter. We must have the patience to learn all there is to know about a particular business before we invest our time, energy, and financial resources in it.

As an introduction to the complexity of making business decisions, consider the experience of Mr. and Mrs. Smith, who are considering buying a business. They illustrate how those who move slowly and carefully have the best chance to survive.

John and Marie Smith have some free time on their hands now that their children are in college. Marie is from a restaurant family and has dreamed of recapturing the childhood joy she knew from being involved in the operation of a restaurant. John, a full-time executive, can use his business contacts to help fulfill his wife's ambitions. Marie will handle the operational details, such as hiring talented people to staff the operation. Knowing Marie's background and her decision-making ability, and realizing that restaurants can be very profitable, John believes this type of gastronomical venture will be right for them.

The Smiths choose to investigate restaurants in a coastal resort area about an hour from the city. A large, year-round tourist population guarantees a sizable group of people who regularly dine out. John and Marie proceed carefully, arranging for both a lawyer and accountant to help them. They are undecided whether to build the restaurant and develop the clientele from scratch, to buy an established restaurant and run it their own way, or to buy into a nationally franchised restaurant chain whose meals must be prepared in a manner dictated by the franchise.

The attorney first discovers that the local zoning board is hostile to the construction of a new restaurant because of the already existing urban sprawl. However, the zoning board is receptive to the construction of the nationally known franchise, deciding that the addition to the existing overdevelopment would be outweighed by the attention the franchise would bring to the town. An attempt to fight the zoning board's peculiar prejudice would be costly and time-consuming, and would only serve to hurt the restaurant's business when it finally opened. These considerations convince the couple to drop the idea of building their own restaurant and to concentrate on the other two possibilities, buying an existing restaurant or buying into a franchise.

A check of local real estate brokers reveals that there are two restaurants on the market. One is on the shore, available at a bargain price, and the other is farther inland, with a good reputation and a high asking price. Upon request, the franchisor mails John and Marie a disclosure statement, an earnings claims document, and a copy of the franchise contract. These papers are forwarded to the attorney for evaluation. Because each state has different laws pertaining to franchises, the attorney must study what effect the contract will have on the operation.

Meanwhile, the Smiths concentrate on evaluating the potential of the two restaurants that are for sale. The proprietors of both restaurants grant interviews and access to the documents John and Marie want to see.

The reason that the owners of the successful inland restaurant are selling becomes obvious at the interview. They are beyond retirement age. They are tired of the hectic life of food preparation, but their pride in what they have accomplished is visible as they point out the various facets of their operation. In a convincing manner, they discuss recipes, cooking tips, and the preparation of the house specialties. They provide photocopies of 3 back years of income tax returns, which John and Marie forward to their accountant for analysis.

When John and Marie visit the shore restaurant, they observe that too much of the restaurant's floor space seems devoted to the bar. During the brief time they are there, one of the few diners complains to the waitress that the chowder is too salty to be eaten. The owners, a couple in their forties, seem anxious to get out of the restaurant business. The owners also provide copies of their tax returns.

At home, John and Marie discuss the two restaurants. Both operations buy their raw food from the same markets. The kitchen equipment of each is in good condition, although the facilities of the inland restaurant are a little older. County health officials state that there has never been a problem with either restaurant. The employees of the inland restaurant seem to be about a generation older than the staff of the shore restaurant. The shoreline restaurant has a smaller parking lot than the inland restaurant, but more of its customers walk to dinner. There is an empty lot next to the shoreline restaurant that the owners have offered to include in the sale. The lot could be cleared and paved to provide additional parking, but it is not clear if the local zoning board would allow the improvement.

The next day John and Marie meet with their accountant to go over the figures presented by the two restaurants. The inland restaurant shows good, consistent profits. The income and expenses are in a ratio that is normal for restaurants, indicating an efficient operation. The tax deduction for repairs is small, so presumably the machinery is in good working order. The payroll records show little turnover. The inland restaurant seems to keep everyone happy—customers, employees, and owners.

Marie notes that the menu prices at the inland restaurant were moderate for an eatery with a good reputation. The accountant confirms that the restaurant would be even more profitable if the menu prices were raised to keep up with inflation. The accountant and the Smiths postulate that the restaurant's reputation would survive modest price increases without losing many customers. Since the asking price of the business seems to be composed of the value of the assets and 2 years' profits, raising prices might make a significant dent in the length of time needed to recover their investment.

Casual conversation with local residents failed to reveal anyone who would admit to eating at the shoreline restaurant. The figures for the shoreline restaurant seem to confirm the emphasis on tourists, with little effort to attract repeat customers. The accountant points out that an unusually high percentage of the restaurant's income is from the sale of liquor, a ratio more akin to a bar and grill. The couple and the accountant agree that they must consider, in addition to the purchase price, the cost of renovations necessary to deemphasize the cocktail lounge. This is still a relatively inexpensive purchase since the asking price for the shoreline restaurant is a figure representing the value of all the assets and less than 1 year's profit, a profit that was low to begin with.

After meeting with the accountant, John and Marie go to their attorney to complete the investigation of the two restaurants and compare these opportunities with the franchise offer. The attorney says the owners of both restaurants have clear title, free of legal attachments and mortgages. Also, the attorney sees no obstacle to obtaining a building permit to remodel the shoreline restaurant. However, because the zoning board can be unpredictable, the attorney recommends that an escrow clause be written into the purchase contract so that John and Marie do not buy the lot unless paving is approved. The part of the restaurant purchase price to be paid to the seller for the empty lot would be placed in escrow, in trust of a local bank until the zoning board reaches a decision. If the zoning board were to approve paving, the bank would turn over the escrow fund to the seller to complete the transaction. If the zoning board were to forbid paving, the bank would return the escrow fund, the purchase of the adjacent lot would be canceled, and the lot would still belong to the restaurant's former owners. A contract escrow clause protects the buyer from paying for something unusable, while the rest of the sale goes through.

According to the attorney, the franchise offers the usual entanglements, although it is no fly-by-night scheme. King Craw, the Louisiana-based seafood chain, is rated highly by business credit bureaus even though it has been in business only a few years. The attorney attributes King Craw's success to the direction it gives to franchise operators, as evidenced by the guidelines and restrictions contained in the contract. Other King Craw owners contacted by the attorney (from the list provided in the disclosure statement) confirm that controls are tight. However, the attorney points out that there is no way to tell whether the failures of some outlets were really due to the tight controls or to the public's mixed reactions to seafood restaurants. To judge the possible effects of the company guidelines, the contract has to be studied very carefully.

In return for the franchise fee, King Craw provides the basic supplies and a completed building ready for operation. The franchise purchaser has no say in the location other than to select the town to do business in. The company then sends professionals to choose the exact site and to see that the building is constructed according to company specifications. According to the contract, the company arranges for all licenses and permits, provides publicity for the grand opening, and handles all advertising, national and local.

The franchise purchaser must pay all other costs of day-to-day operation, including freight charges for the shipment of genuine Louisiana crawfish. Most of the specialized foodstuffs must be bought directly from the company at the company's price. Certain seafood can be bought locally if it meets company specifications; lobsters, for example, must weigh between 2 and $2\frac{1}{4}$ pounds. The menu itself is limited to the dishes sold at all the other franchise locations. The contract allows the company to set menu prices, restaurant hours, and even the design of the employees' uniforms. The attorney thinks these guidelines are reasonable to protect the integrity of the King Craw image.

In addition to a one-time franchise fee, the operators must also pay King Craw a percentage of the receipts. The attorney points out that there is no minimum sales provision; the contract cannot be canceled if a monthly sales quota is not met.

Of greater concern is that the company does not protect the location; it has the right to put up new outlets wherever it pleases. If the sales volume from John and Marie's outlet is heavy, the company could open another King Craw nearby. The figures on the earnings claim document state that a typical King Craw makes a 10 percent profit on sales that average $500,000 a year, a decent return on the $250,000 franchise fee. However, if the company can limit John and Marie's profit by licensing competitors, the incentive is reduced.

The attorney agrees that, given the measure of Marie's faith in her skills, the franchise would be too limiting to her. The restaurant opportunities seem to offer more in the way of self-determination. In trying to summarize the reasons for the choice of one of the restaurants, John, Marie, and the attorney arrive at some conclusions. The shoreline restaurant appears to be a bargain purchase, even including the cost of redesigning the interior. The inland restaurant offers the chance to buy in on a successful tradition, with the challenge of upholding it. The shoreline restaurant has the greater profit potential in the long run because of its favorable location. However, first, its earnings picture must be turned around.

Because Marie has the skills to make either restaurant pay off, the Smiths eventually decide, with the help of their counselors, to accept the greater challenge. They decide to buy the shoreline restaurant. Another couple, with different skills, could easily have reached a different conclusion. For example, a less well financed investor might have chosen the inland restaurant because it would be an income producer right away. On the other hand, John and Marie's careful consideration of price, location, profitability, and various complicating factors enables them to predict what true effect each of the three choices would have upon their lives. In the end, they made their selection not on the basis of appearance, but on perceived realities.

Business decisions are not easy—especially the far-reaching decision to enter business in the first place. In making your decision, do not let your judgment be clouded by dreams of success or by fears of failure. Listen to suggestions from your banker, your lawyer, and your accountant, and then consider the future coolly and calmly. Whatever the results of that decision are, you and your family will feel better about it if you have left no stone unturned in your preparation. In an endeavor as serious as entering the business world, you must take the steps necessary to give yourself the best possible chance of success.

2
FINANCING THE SMALL BUSINESS

Your ability to finance a business depends on your business reputation and prospects, the amount of money you need to start and operate the business, and your personal resources.

If you are well known in your field or have a product or service which others believe will be profitable, you may be able to finance your venture with a substantial amount of outside capital. But if you are starting without these advantages, you will have to depend on your own resources. Many businesses have successfully started on an owner's personal savings, the mortgage raised on a house, or cash borrowed against insurance policies. However, few businesses can operate long on personal financing. Inevitably, more money is needed for additional assets and for operating funds to pay for wages, supplies, and merchandise and to extend credit to customers. Also, it may not be advisable to place all of your personal resources into a business venture because of the risk of losing all of your capital.

Searching for funding can provide a sobering glimpse of reality. Potential backers may be candid about your idea and prospects. Also bracing can be the task of drawing up financial projections and financial statements. Loan applications will provide insight as you detail all business charges and expenses. Full attention to the financial demands of the business can prevent your dream of enterprise from becoming a nightmare.

EVALUATE YOUR CAPITAL REQUIREMENTS

Insufficient capital is a major problem for the new entrepreneur. Before you take a decisive step, work up a detailed set of figures indicating how much capital you will need to launch your business.

You must itemize expenses you will incur in setting up your organization, including a regular salary for yourself. The actual funds you have to invest from all sources must be sufficient to meet these costs—if they are not, you obviously cannot start your venture.

You must be able to meet three kinds of expenses: *capital* expenses, *fixed* expenses, and *variable* expenses.

Capital expenses are one-time-only costs necessary to bring your business to the point of operation. For example, the purchase of a large machine is a capital cost. A machine that is leased instead of purchased is an example of a fixed expense. A fixed expense is one which must be paid regularly, perhaps every month or every week. Variable expenses are those which fluctuate or those which are unforeseen. The energy costs of operating the machine would be a variable expense, depending upon how much the machine is used. Cash reserves may be necessary to meet unexpected variable expenses.

The following checklists will help you to make a projection of expenses you must meet.

CHECKLIST OF CAPITAL EXPENSES

Capital expenses are costs of:

- Buildings, machinery, equipment, and land used for your business
- Professional fees incurred in the purchase of business facilities, such as real estate commissions, legal fees, and architects' design fees
- Obtaining building permits and zoning changes
- Outside business improvements, parking lots, landscaping, paving, sewer connections, payments for rights-of-way or access routes
- Remodeling or redecorating the inside of the business structure to suit your needs, including rewiring, special pipes, outside windows, and ventilation
- Installation of heating systems and water lines
- Typewriters, fire extinguishers, dollies, vacuum cleaners, and portable tools
- Patents or copyrights necessary to the business
- Promotion or advertising costs for your grand opening
- Neon sign and other displays or exhibitions to be outside the building; for example, a swimming pool company may have a pool constructed on the grounds outside
- Inside and outside lighting fixtures necessary for your store and parking lot
- Shelves, files, cabinetry, and display counters

- Safes, strong boxes, cash registers, and employee lockers
- Burglar alarms, window gratings, antitheft devices, and sprinkler systems
- Water cooler, soda machine, and time clock and punch cards
- Reference books
- Inventory necessary to start retail operations or raw materials necessary to start production
- Vehicles needed by the business

CHECKLIST OF FIXED EXPENSES

- Rent for premises and for leased machinery and equipment.
- Lease of rights for patents, copyrights, rights-of-way, or other rights you must secure to do business.
- Insurance: comprehensive, fire, crime, theft, disaster, liability, malpractice, casualty, business interruption, worker's compensation, marine insurance, business overhead expense insurance, extended coverage for vandalism and malicious mischief, etc.
- Yearly registration fees and certain taxes that are fixed annually, such as the federal highway use tax, federal aircraft use tax, federal alcohol stamps, state automobile license and registration, city property tax, state certification, professional accreditation, registry fees, etc.
- Garbage collection, snow removal, landscaping, ambulance services, building maintenance, exterminators, and furnace cleaners can be paid for monthly, as needed, or on a yearly contractual basis.
- Collection agencies, accountants, lawyers, credit services, and other professionals regularly dealt with can be put on yearly retainers.
- Rotary Club membership, Lion membership, business cards, participation in town fairs or trade show, tickets to the firemen's and policemen's ball.
- Membership in business associations.
- Cleaning of premises.
- Security protection.
- Subscriptions to trade and professional magazines and journals.
- Salary costs not related to sales or production (these wages vary with volume of business and overtime): secretaries, typists, bookkeepers, personnel department, research and development staff, and management positions.
- Supply costs not related to production: paper, typewriter materials, ledgers, pencils, stamps, paper towels, toilet paper, staples, paper clips, paper cups, etc.

CHECKLIST OF VARIABLE EXPENSES

These are costs of:

- Production-related salaries, including overtime pay
- Commissions paid to sales personnel
- Contributions to employee health and medical plans and to company profit-sharing plans
- Rental of extra machinery to match peak-production demands
- Social Security contributions made on behalf of employees
- Federal and state unemployment taxes
- State and federal fuel taxes, excise taxes, customer and tariff duties, sales taxes, and value-added taxes
- Advertising
- Delivery
- Telephone
- Repairs
- Heat, utilities, and air conditioning
- Uniforms, work clothes, safety shoes, and equipment provided by employer
- Disposal of industrial wastes, incineration, purification, and other special handling
- Compliance with federal, state, and municipal regulatory agencies, such as the Environmental Protection Agency
- Travel and entertainment to solicit new business
- Customer services such as warranties, repairs, and complaints
- Raw materials and supplies necessary for production

PROJECTING INCOME

You may have the money to invest and the energy to work hard, but if you do not have customers, your business will fail. The fact that many businesses open and then close is evidence that their owners were able to estimate and raise an initial investment to start the business, but that they were not capable of developing and keeping sufficient sales volume to meet expenses and return a profit. Although it is difficult to project an income return for a new business, you must make a realistic estimate based on your experience and the experience of others. If you are unsure of your income prospects, you are really not going into business, you are gambling—betting against the odds.

Even when you are experienced and optimistic, you should make an in-depth appraisal of your prospects and have someone else check