7 Mistakes Small Business Owners Make When Investing in Their Business

Each year, millions of small business owners skip contributing to their retirement plans and tell their accountants and financial professionals that they are instead going to "put it back into their business". In some cases, it's a great decision, in others, it's a grave mistake. If you must put all your eggs in one basket, at least follow Mark Twain's advice: "Put all your eggs in one basket and *watch that basket*."

Understanding the mistakes others have made when investing in their own businesses can help you construct a plan to build an asset that can outlive you, understand your rate of return and impact your bottom line.

#1 They don't groom a successor

#2 They don't maintain adequate liquidity

#3 Avoiding the stock market gives them a false sense of security

#4 Short sighted spending

#5 They forget about local talent

#6 They don't clearly separate business and personal assets

#7 They keep their head in the sand

Mistake #1 They Don't Groom a Successor

Succession planning is probably the most complex problem facing small-business owners (SBOs). So, while investors can simply sell their funds, another advantage that mutual funds enjoy over small businesses is that they are easily transferable. By taking some time to understand the roadblocks business owners face when trying to sell their businesses, SBOs can take simple steps over time to add value and lessen the chaos associated with the transition process.

Kids are statistically the wrong answer
Almost 8 out of 10 small-business owners believe that their children will be the ultimate owners of their business. Only one out of every 3 small businesses survives the transition to the second-generation.

Don't lose hope. By initiating conversations and implementing your succession plan early, you can increase the likelihood that your children will succeed. Two facts are important to remember when considering selling the business to your kids:
1) You can expect to receive less money than you would if you sell to an outsider
2) You are signing up for an enhanced level of parenting and mentoring that may require the assistance of a professional or a coach of some kind.

Failure to Develop and Retain the "Farm Team"
If you find that your family doesn't have the ability or the desire to take over the family business, consider looking to one or more of your employees as potential buyers and develop a plan that will allow them to earn equity over time. For many business owners, selfish thinking near retirement may result in seasoned employees either going to work for themselves or someone else.
Setting expectations, challenging, developing and rewarding one or more of your employees as potential buyers can add a tremendous amount to the value of your business when you decide to move on to the next phase of your life. You may also end up with a partner who has a vested interest in making sure that your business maintains a level of excellence.

Mistake #2 Inadequate Liquidity

There are a couple of old sayings in business. One is "cash is king," and another is "happiness is a positive cash flow." Most failed businesses, up to 60%, say that all or most of their failure was due to cash flow problems. Businesses have to have as their guide another old saying, "Nothing matters more than cash." Making a profit and having adequate cash flow are essential for survival, but cash management is the key to the *growth of a business.*

Just like an individual or a family, businesses need a cushion of cash to rely on. This can provide security in unstable times and provide the opportunity to take advantage of strategic investments or even take advantage of purchases that may reduce costs.

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Liquidity at Death
If you're like most small business owners, you hate insurance as much or more than you hate taxes. This is one area where procrastinating can cost you and your family dearly. Term life insurance is more affordable than ever, and can get most business owners through the time in their careers when they are carrying heavy debt or when cash is tight. Just remember that paying off debt isn't the only reason to own a life insurance policy, many small business owners neglect to purchase enough insurance to provide income for their families in the event of their untimely death. Properly structured policies can come in handy in future estate planning techniques as well.

Permanent insurance is often the best choice unless you can't afford the premiums. If your cash flow or debt situation forces you to use term insurance, be sure to purchase it through a reputable company with strong ratings. You should also consider purchasing a policy that has a conversion feature. A conversion feature will allow you to purchase, or "convert to" permanent insurance during the term of the policy. In addition to providing flexibility for your financial planning needs, a convertible policy will allow you to purchase permanent insurance in the future, even if you become ill. Be sure to discuss these strategies with your Financial Planner.

Mistake #2 Avoiding the Stock Market Gives Them a False Sense of Security

Covering or eliminating just one part of your risk doesn't necessarily mean you can rest easy. If you're naturally averse to risk, chances are your fears shouldn't be confined to just the stock market. Find a Financial Planner who understands and is willing to work with you to help you understand the various types of risk that affect your family and your business. It's easy to look at one part of your situation and think that reducing or eliminating it will alleviate all the dangers that are in your path, but by truly understanding risk, you may find out that it's not just the stock market that's keeping you up at night.

Take time to understand the risks
It pays to play a quick game of "worst case scenario" with all of your professionals. Asking your property and casualty agent, your broker, your life insurance agent, attorney, and CPA to specifically address the number one danger facing you and your business every year will allow you to work with your Financial Planner to determine a course of action to manage those risks. Understanding how tax diversification, time diversification, investment diversification, and controlling the risk of life events by self-insuring or transferring risk to an insurance company can help you to achieve an ever-increasing sense of security that the investment you've made in your business is a wise one.

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Mistake #4 Short Sighted Spending

Some of the most common shortsighted spending errors arise in the name of saving money on taxes. Business infrastructure expenses are necessary, to be sure, but getting caught up in a long-term tax strategy that revolves around getting new paint every year is often a path to destruction. Remember, as your accountant strives to provide "value" to you for their services, be careful that they're not putting too much emphasis on decreasing the amount of income tax that you pay to the point that they're actually willing to limit your income! Employing such a strategy over a prolonged period of time can leave you with excessive fixed payment obligations and a lack of cash reserves and retirement savings, especially if you're nearing retirement.

Additionally, if your accountant has to deliver bad medicine, sometimes they feel like they're able to give you a spoonful of sugar along with it by giving you "permission" to purchase something in order to minimize the bite. The pain of purchasing a new vehicle or piece of equipment pales in comparison to the pain of having a relatively large tax bill. We often refer to the farmer with a new pickup truck every year as an example. It seems less painful to write a check for a vehicle than to write a check to your financial advisor for a retirement savings plan or to write one for a much smaller amount to the IRS for taxes.

In short, if your income is inconsistent, you shouldn't expect your tax bill to be consistent. If your accountant is resistant to this notion and focused on limiting your income in order to minimize your taxes, you should spend some time with them to clarify your goals, especially around cash flow, cash reserves and savings. There are times when purchases as tax-reduction strategies are critical to the survival of the business, and there are situations where their repeated use is acceptable. If you're using a long-term spending strategy to reduce your tax burden, you may want to take a second look, or get a second opinion.

Mistake #5 They Forget About the Local Talent

Especially in rural America, small business owners often deal with the reality that their kids aren't interested in taking over the family business. Whether they want to move away after college, don't want to deal with the stress of the business or simply have other ambitions, members of the second generation often choose a different career path.

Though finding out that your children don't want to work in the business is an emotional experience, it's not the end of the world. It's important to remember that there are kids at the local high school whose primary goal is to live and work in their hometown. You may want to begin "prospecting" for younger help. Who knows . . . one of those kids might even be one of your grandkids.

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Getting your grandkids or other local students involved in your business at an early age and teaching them the value of showing up for work everyday, working hard and providing a valuable product or service for the community will supplement their formal education. If they show a liking for the business you're in and you can begin to groom them as a successor, well, that's an added bonus.

You may shudder to think about the prospect of creating a job description for an intern or summer helper, but you'd be surprised how easy it can be to find a hard working student to help you with some of the tasks you are either putting off or avoiding all together. Rather than trying to come up with a comprehensive list or description, try coming up with a project or two that you'd like to tackle if you had some help. Once you know what your objective is, you can contact the counselor or secretary a local high school. They usually have a pulse on who the best workers are. From there, you may consider talking to a vocational or business teacher to find more potential candidates.

Mistake #6 They Don't Clearly Separate Business and Personal Assets

Your life is your business and your business is your life. As business owners, sometimes it's hard to separate the two. You might be used to making all the decisions that would have to be made in a large organization, from setting the vision and goals for the company, trying to meet those goals, all the way to making sure there are paper towels in the restroom. There are perks that go along with owning the business, and often, either working out of the home or close to home can be one of those perks.

Whether you're in a partnership, just starting out, or nearing retirement, it pays to understand the PIE *concept*. When I talk about PIE as it relates to your business, or your operation, I'm referring to Property, Income, and Equity.

Property
"Fifty-Fifty"...

That's by far the most common answer I hear when I ask business owners with partners how they own the business. Hopefully, you've already started to pick apart the sticky layers of complexity that comprise small business ownership, but the property is often the easiest layer to fix. When one partner wants to expand and the other doesn't, one of the most frequent hitches involves real estate expansion. Often, when I bring up the concept of the more growth-oriented partner seeking an outside partner on the real estate, yet still offering a 50% ownership stake in the business (or vice versa), they are able to reach some sort of an agreement. It's an often overlooked idea that can prove pivotal in situations where growth is stalled.

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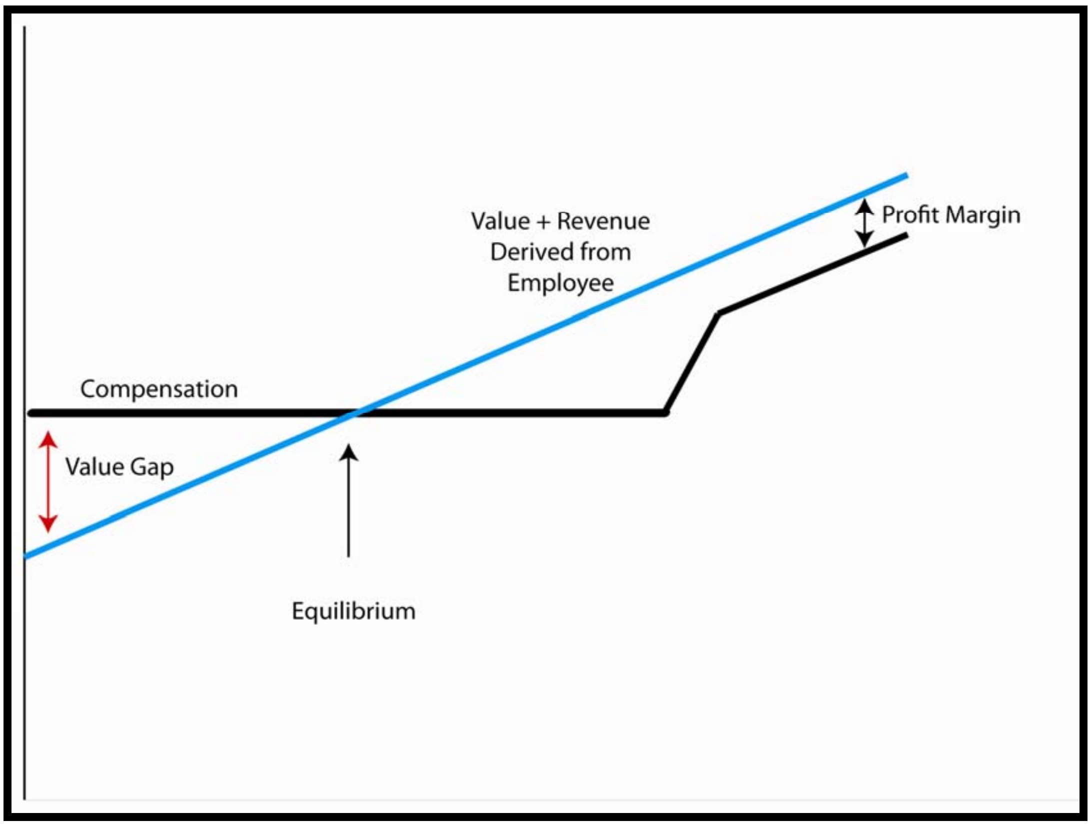
Viewing the property as a separate entity and maintaining the freedom and flexibility to have partial owners outside of the partnership can often be a compromise that suits both partners.

Income

The hardest move to make in small business is adding your first employee. My wife came to work for me for almost two years before we were able to ramp up our activity level enough to hire another employee. It's a tremendous amount of risk, and more often than not, you have to take a leap of faith before you're financially ready to take on a new employee. The older you get, the less appealing it seems and the more likely you are to stay the course.

When you do decide to bring on an employee, one thing is almost universally true: it will take a while for that employee to bring enough value and revenue to the business to offset the amount of money you're paying them. There are really three phases of income for new employees, and understanding them can help you set clear timeframes and expectations during the hiring process and beyond.



1) The Value Gap – During this phase, the employee will be getting paid more than the sum of the value and revenue they are bringing to the business. It's important to let them know that you understand that there is a learning curve, and that there is a gap between these two numbers. If they are not in a revenue-generating position, it's important to attempt to quantify the value of their support role as it pertains to your quality of life and define expectations around what you

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hope to get out of the relationship (long weekends, shorter hours, vacation time, etc.) and how soon you would like to achieve that goal (6 to 18 months, usually).

2) The Point of Equilibrium – Obviously, this is a very subjective point, but think of equilibrium in terms of the balance between the value and revenue your employee brings to the business and amount of compensation they receive for the work. Hopefully at some point, your employee will be worth more money than they're getting paid.
   It's important to acknowledge this achievement and continue discussions about the continued progress they need to make in order to further increase their compensation. In exchange for the risk of hiring, managing and training this employee, you should expect to earn some profit off their continued efforts, for a while!

3) The Profit Margin – Don't get greedy! The margin of profit, or the difference between the value and revenue that the employee brings to the business and the amount that you pay them cannot get too large, or they'll decide to become your competition. Once your employee has passed the point of equilibrium, it's important to revisit their salary and commission arrangements at least twice annually to make sure you're remaining competitive and continuing to profit from the relationship. On the revenue side, your accounting systems should be equipped to provide the data that you need. On the value side, you'll have to weigh your quality of life gains from the relationship on your own terms.

If you understand and remain aware of these three phases in an employer – employee relationship, your chances of retaining a key employee will increase dramatically.

Equity

The last piece of the pie is the equity portion. The promise of equity can be a magical thing when it comes to luring young talent into your business. If you're looking for someone with an entrepreneurial mindset, as you should be, you may not be able to find a willing employee without providing an option that involves an equity stake down the road.

It's important to keep these three equity components separate when you consider making an offer of equity:

1) How much of the profits, if any, are you willing to split with someone else?
2) How soon are you willing to allow someone else to have a say in the process of making major decisions?

Having solid accounting practices in place and understanding the value of your business outside of the buildings that house it and the land on which they sit can put you in a position to discuss equity ownership with potential employees, partners or buyers.

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Mistake #7 They Keep Their Head in the Sand

I'm no longer surprised when I meet with small business owners who don't keep an annual statement of net worth. The common denominator in all of the small business failures I've witnessed over the past twelve years is a lack of adequate accounting. Whether it's poor oversight, laziness, denial, fear of spending the money to have a competent team or downright complacency, individuals who own their own businesses and cannot answer fundamental questions about their income, expenses and net worth are ripe for trouble.

Having clear oversight of the books and understanding the variables that determine profit and equity growth lay the foundation for success at a high level. It's incredibly simple to understand the trajectory your business is on if you have a sense of the numbers, and you can't fix your problems if you aren't willing to acknowledge them.

In order to get your head out of the sand, you may need to hire someone with an outside perspective to take a look at your situation and provide some insight. Ultimately, you alone are responsible for the success of your business, but having a coach who can bring some different ideas and approaches to the table can mean the difference between coasting into retirement or creating something that can outlive you.

Jeremy Overton has spent the last 12 years educating and motivating individuals, families and business owners who are interested in having a greater impact on their communities, the people they love and the causes they support.

Both as an author and presenter, Overton provides a framework for his audience to understand and simplify the complex ideas and problems they face. Jeremy's work is designed for entrepreneurs who are looking to clean up messes in their organization, gain a competitive edge or distinguish themselves from competitors in the marketplace.

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