

# RESTRUCTURE OF THE ENTERPRISE TO MICRO- ENTERPRISE TO USE TAX ADVANTAGES IN ORDER TO INCREASE PROFITABILITY, CASE STUDY

## UZŅĒMUMA PĀRSTRUKTURĒŠANA MIKROUZŅĒMUMĀ NODOKĻU PRIEKŠROCĪBU IZMANTOŠANAI UN RENTABILITĀTES PALIELINĀŠANAI, PIEMĒRA ANALĪZE

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**Abstract.** *At 01/09/2010, Micro-enterprise Tax Law came into force in Latvia. The Law permits paying of single micro-enterprise tax at the rate of 9% from turnover. Innovations of the article – there have been insufficient studies on impact of this law. The aim of the paper is to discover whether legislation amendments permit the enterprise to reduce costs via network of branches by restructuring thereof into micro-enterprises. The study is based on a case study. Used methodology: study of financial documents, PEST analysis, interview, questionnaire. During the study, cost/revenue analysis has been conducted, two cash flows have been created. Results of the study are summed up in conclusions and demonstrate that restructuring of branches into micro-enterprises permits the companies to increase profitability and to decrease the costs (question of the study has been answered affirmatively), competitiveness of company is growing, and the restructuring must emphasize surveyor's motivation as well.*

**Keywords:** *competitiveness, micro-enterprise, tax advantages.*

### **Introduction**

At 01/09/2010, Micro-enterprise Tax Law came into force in Latvia. The Law permits paying of single micro-enterprise tax at the rate of 9% of turnover. Innovations of the article – there have been insufficient studies on impact of this law. The aim of the paper is to discover whether amendments of the legislation permit the enterprise to reduce costs via network of branches by restructuring thereof into micro-enterprises. The study is based on a case study.

The enterprise X is a land surveying and territorial planning company based in Riga, Latvia. It started active work in 2005 and is currently employing 160 workers. The enterprise X has 29 territorial

branches and the 2010 turnover was 5 million EUR. The regional office network was created in the time of property boom during the demand for surveying service. The surveying service market in total was 15 to 20 million EUR. However, at this period of recession, it has shrunk 3 to 5 times. The main issue is that the competitors mostly are very small companies consisting of one to two surveyors that are also the owners that work at home. Therefore, they have minimal fixed costs, moreover, they show turnover so little officially, that they pay very little in taxes.

As the market diminishes, due to the crisis, the enterprise X must optimize their costs and find a way not to lose their main clients – “Latvenergo”, “Latvijas Mezi” and “Lattelecom”, the large, government-owned companies with more than 100 million EUR turnovers. The individual clients are lost, as the competitors can provide the service at a much lower price. One of the suggestions is to reposition all the surveyors from regional towns as micro-entrepreneurs and sell them the enterprise X franchises. This would remove all fixed costs and decrease the tax payment to just the value added tax at 22%.

Firstly, the strategic environment will be analyzed using PEST and the situation will be modeled using a fishbone diagram. Secondly, the employee motivation and its possible changes will be explored. Lastly, the financial background of this possible decision will be analyzed. Data will be taken from primary sources – an interview with the enterprise X CFO and a survey that will question 50 surveyors employed in the enterprise X.

Time limitation: the years 2010 to 2011. Other limitations: not all of the enterprise X financial data could be accessed, therefore some of the calculations needed to be done with estimates and the surveying results did not give answers to many motivational questions, thus more precise primary data collection should have been done.

## **1. Main findings**

According to the Maslow’s theory, a number of changes can take place when an employee becomes a micro-entrepreneur. The Maslow’s pyramid shows, which needs prove to be endangered with the changes according to the survey. Most importantly, 50% of the surveyors fear the changes, therefore, will lose their current safety needs.

### **1.1. Financial analysis**

#### **1.1.1. Costs and revenues per surveyor**

The enterprise X can divide the revenues and cost of the surveying department per surveyor. In this way, the importance of cost cutting can be stressed.

Table 1.

Total calculations of revenues and costs of the surveying department per surveyor in the enterprise X, 2010 (11.)

<b>Option 1</b>	per surveyor	total
	EUR	EUR
<b>Revenues</b>		
	2,400	312,000
<b>Costs</b>		
Fixed costs	(735)	(95,550)
Variable costs	(141)	(18,330)
Salary	(569)	(73,970)
Corporate tax	(424)	(55,120)
<b>Balance</b>	<b>531</b>	<b>69,030</b>
<b>Option 2</b>	per surveyor	total
	EUR	EUR
<b>Revenues</b>		
Franchise	200	26,000
Equipment rent	200	26,000
<b>Costs</b>		

Table 2.

The current financial situation in the enterprise X, 2010 (11.)

<b>Option 1</b>	EUR
<b>Revenues</b>	
	2,400
<b>Costs</b>	
Fixed costs	(735)
Variable costs	(141)
Salary	(569)
Corporate tax	(424)
<b>Balance</b>	<b>531</b>

The current situation (Table 2), at which the costs per surveyor are very high. However, due to the market situation reasons, the revenues exceed the costs.

Table 3.

The financial situation after the reorganization in the enterprise X, 2010 (11.)

Option 2	EUR
<b>Revenues</b>	
Franchise	200
Equipment rent	200
<b>Costs</b>	
Management salaries	(43)
Fixed costs	(3)
Variable costs	(1)
Corporate tax	(60)
	<b>293</b>

Table 3 illustrates the situation after reorganization. The revenues have decreased a lot, but the costs are now diminished to the minimum. This option is guaranteeing additional flexibility and ability to better adapt to the market changes. Hence, as the costs are lower, even periods with low revenues will not bring losses.

#### 1.1.2. Finances from the surveyor's point of view

The possible changes can also be viewed from the surveyor's point of view, and the calculations of the monthly salary give a strong reason why they must consider them.

Option 1:

$$\begin{aligned} & \text{Monthly revenue minus value added tax * salary coefficient(9)} \\ & = (2400 - 528) * 0.35 = 655 \text{ EUR} \end{aligned}$$

The current situation, when surveyors are employees is shown in Option 1.

Option 2:

$$\begin{aligned} & \text{Monthly revenue} - \text{sole trader tax} - \text{fixed and variable costs} \\ & - \text{franchise payment} - \text{equipment rent(9)} \\ & = 2400 - 216 - 300 - 240 - 200 = 1444 \text{ EUR} \end{aligned}$$

The calculations prove that Option 2 is favorable, since the salary is substantially higher. This is the most important argument why surveyors must reorganize to be micro-entrepreneurs as soon as possible.

### 1.1.3. Yearly Cash flow analysis

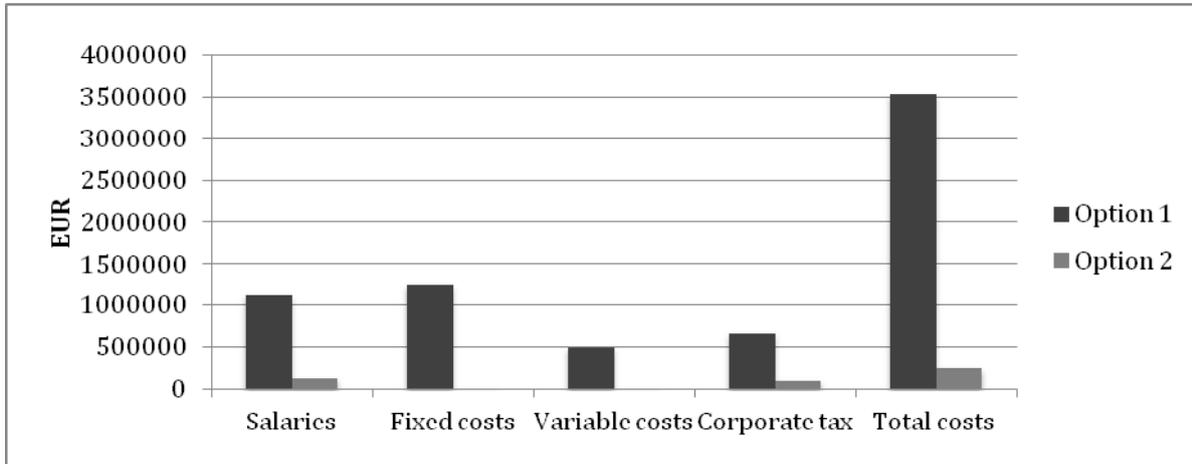


Figure 1. Costs in both options per annum in the enterprise X (10.)

The current cash flow is positive, but it is mainly due to two aspects, very low wages and great deals with corporate clients. However, the main issue is the high costs. Figure 1 shows how Option 2 decreases the costs and enables the surveying department to work more effectively, thus the balance will increase.

## 2. Analysis

### 2.1. Motivation

It is important to motivate the surveyors in both financial and non-financial ways. Approximately 70% of the surveyors that would agree to this change will have a much greater opportunity, but the change will also mean that they will be independent now, able to make their own decisions. Thus, the number of clients and their salary would be dependent on how they work, in fact their salary could easily double as shown in the financial analysis. Moreover, they will still be able work with corporate deals, which would not be possible if they would work individually. 30% of them consider changes needed, as the wages are too low. This is the main reason why at least these 30% will be motivated enough to work. Moreover, a less important change is that the reorganization gives to the surveyors an opportunity to build their own team to satisfy their social needs, which is now an issue. However, the main opportunity that comes with the reorganization is for them to fulfill their esteem and even self-actualization needs, which many of them hope for. On the other hand, some of the employees will not be able to cope with the changes, even their physiological needs could be endangered. Moreover, those who were enjoying the benefits of being an employee

will now have to take the risks themselves, which might mean losing some of the safety needs. 50% of the questioned surveyors fear the changes. Another issue is that the surveyors will not any more be able to fulfill their social needs, since there will be almost no office work.

The survey shows that 50% of the surveyors fear the changes, which proves that the enterprise X must arrange meeting with the surveyors to explain how exactly the changes will happen. However, almost all the more experienced surveyors felt proud of their job and wanted to reach the two last levels of needs, and the changes would give this opportunity. Even though the wages are low (by EUR 200 lower than in Lithuania) and 30% of the surveys consider them low, the results demonstrate that only 40% of the surveyors want to put more effort into their job in order to earn more. Therefore, the enterprise X must emphasize non-financial gains to motivate the surveyors. From the surveyors' point of view, the reorganizing is highly beneficial.

## 2.2. Strategic analysis

### 2.2.1. PEST

Political	Economical
<ul style="list-style-type: none"> <li>• The recession that started in 2008 increased the number of those companies which do not pay all the taxes, gray economy accounts for 30 to 50%(7)</li> <li>• Social insurance tax paid by the employer – 24.09%</li> <li>• Sole traded tax is 9% of the turnover</li> <li>• Value added tax is 22%</li> <li>• Corporate tax is 15% (6)</li> <li>• Land reform till 2014, a lot of municipalities and private persons will use surveying services</li> </ul>	<ul style="list-style-type: none"> <li>• Real estate market number of transactions has decreased by 70% (9)</li> <li>• The surveying market has decreased from 15–20 million to 3–5 million EUR (9)</li> <li>• Unemployment rate – 14,5% (7)</li> <li>• The average salary fell 25% in 2009, and has decreased by another 3.5% in 2010(8)</li> </ul>
Social	Technological
<ul style="list-style-type: none"> <li>• People are not motivated and even not financially possible to choose companies that pay taxes.</li> <li>• The consumer confidence has stayed low ever since the recession, being the 4<sup>th</sup> worse in the world in 2010 (5)</li> <li>• The austerity measures cause the society to disbelieve the government, thus avoiding paying taxes. 6% of the citizens do not pay taxes at all (7).</li> </ul>	<ul style="list-style-type: none"> <li>• ISO 9001 standard for all services (9)</li> <li>• A lot of equipment (computers, software, tachymeter's, vehicles) purchased that should be rented to the surveyors not to suffer losses (9)</li> <li>• An electronic system as a service that can store the survey data (9)</li> </ul>

<b>Legal</b>	
<ul style="list-style-type: none"> <li>• Even though gray economy accounts for 30–50 (7) per cent, the legal forces are not able to control it</li> <li>• The State Revenue Service does not cooperate with entrepreneurs to find a way to solve the gray economy issues</li> </ul>	

Figure 2. PEST analyses of the enterprise X, 2011

The PEST analysis shows that restructuring is favorable, probably even vital to survive. Political aspects and increasing real estate tax rates (approximately 1%) as well as value added tax (+4%) (6) rates have an impact on the enterprise X in two direct ways – increasing production costs and decreasing consumer purchasing power. Firstly, the taxes increase the production cost, which is crucial if many of the competitors choose to show so small revenue that taxes rates are not important. Secondly, the increasing tax rates do not motivate and possibly do not even give the opportunity for consumers to choose the enterprise X, which offers the service at a 30% higher price, but consumers choose purely the cheapest offer. The market is diminishing, which means that reorganizing is needed and fixed costs, which are now EUR 735 for one surveyor, must be decreased, to regain individual customers.

### **2.2.2. Fishbone diagram**

The inability to compete for an individual client (the enterprise X has a market share of 10% of the individual clients) is caused by several aspects (9). The methods employed are too costly because of the offices and other fixed and variable costs (that account for more than 1200 EUR monthly per one surveyor). There is too much machinery (20 unused vehicles, 15 surveying equipment kits, at least 20 computers with expensive software) that should be maintained in good condition and depreciated.

Approximately 25% of the equipment is not used, 50% of its initial value is depreciated. Eight people are currently employed for management; the costs are increased also by the fact that surveyors are employees not micro-entrepreneurs. This restructuring could solve all these issues. Most importantly, offices should no more be rented, the machinery required by the surveyors could be rented to them, the rest could be sold. Another strong argument is that reducing the number of managers could decrease the management costs. No more than four will be employed after the reorganization. Another important reason to

restructure the enterprise X is that a lot less would be paid in taxes and profitability would be increased.

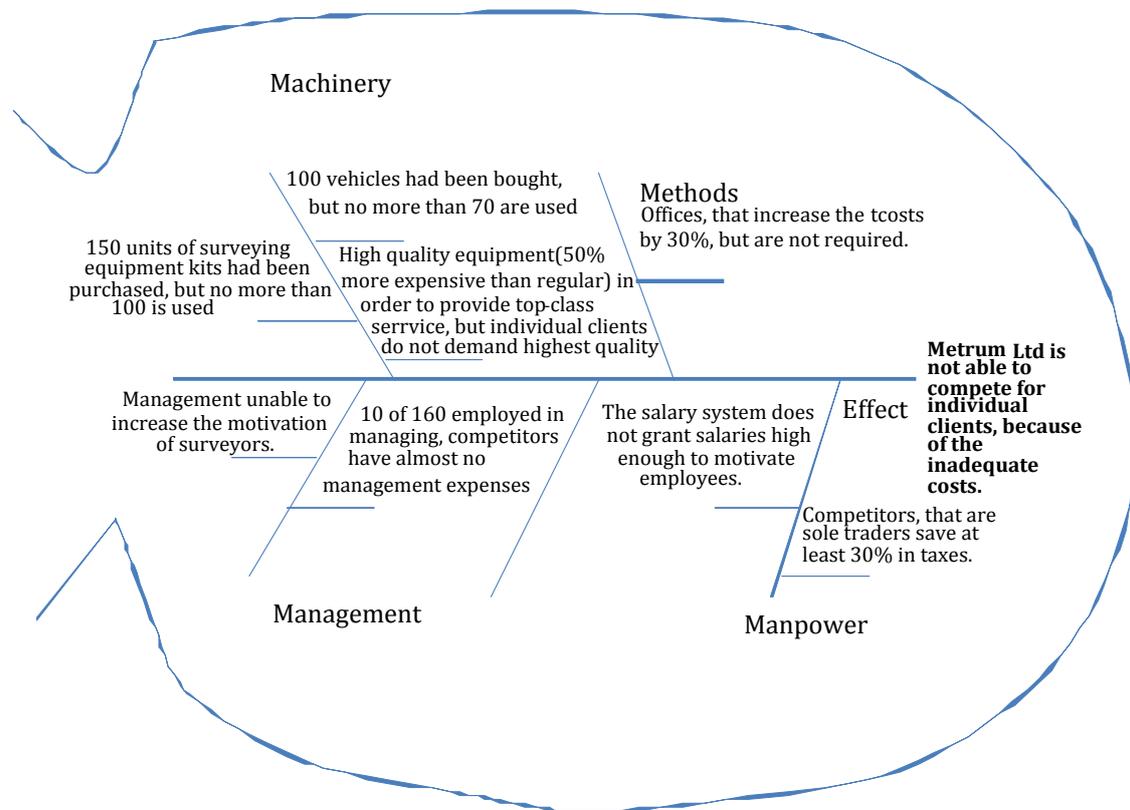


Figure 3. Fishbone diagram

## 2.3 Financial analysis

### 2.3.1. Costs and revenues per surveyor

The current situation in Option 1 does not show losses, since the revenues exceed the costs. However, this is mainly due to the large corporate client deals with "Lattelecom", "Latvenergo" and "Latvijas Valsts Mezi", which account for more than 80% (9), more than 10 million EUR are scheduled for surveying services in the budget. Another positive aspect is the ongoing land reform (large territories should be surveyed in order to divide them into the new regions), which has increased the surveying market to approximately EUR 15 million annually till 2014, when it will end and the market will be worth EUR 3 million and the corporate deal values will decrease. This way of organization cannot create sustainable profitability, due to the loss of individual client market. In the short run it is working well, but the long run will show that costs are too high as the market will decrease five times. Until the end of land reform in 2014 and the end of large contracts, the enterprise X must

reclaim individual clients, to maintain its market share, which is 25% (9). To do this, the enterprise X plans to introduce a franchise system, hence remove almost all costs. This would guarantee that revenues exceed costs, no matter the decision in the market. However, one term would be that the surveyors will be obliged to work with individual clients in order to receive jobs in the corporate deals. Franchise cost would be 10% of the monthly revenue, but not less than EUR 200, which will cover the administration costs and yield profits. While the equipment costs for surveyors would be EUR 200 monthly that would be enough to cover the depreciation costs. Surveyors would rent high-class Bentley surveying equipment and the modern electronic data storage system. This will allow them not to purchase their own equipment, but use the already purchased high-class tools. Option 2 shows the revenues from one surveyor after reorganization. The enterprise X would sell all unused equipment, stop renting offices that will be unnecessary (the surveyors will be able to access the database from any computer with an internet connection) saving EUR 50,000 monthly (10). This together would decrease the monthly surveying department costs from EUR 300,000 to EUR 14,200. The generated revenue per one surveyor after costs has decreased by 45%; however, the enterprise X has now guaranteed that no matter the situation in the market, the surveying department will be profitable. The only costs are 4 management employees and their office, while the franchise revenues could increase if the surveyors are motivated enough.

### **2.3.2. Finances from surveyors point of view**

To motivate the surveyors to become employers, the salary must be at least 50% greater as the survey shows as the level of risk increases. This will happen, because their revenue generated is on average EUR 2400 monthly, EUR 1300 of which is paid in taxes (EUR 424) and fixed (EUR 735) and variable costs (EUR 141). Now, their costs would be EUR 200 for the rented equipment, EUR 200 for fixed and EUR 100 variable costs, 9% micro entrepreneur tax and 10% for the franchise. The salary would increase at least two times as the calculations show. This salary increase should increase the number of surveyors till around 150. The surveyor average salary in Latvia is EUR 650 (9), therefore the surveyors should be motivated by significantly better salary.

### **2.3.3. Cash flow analysis**

After reorganization, two improvements would take place. Calculations have been made taking into account that after the restructuring the enterprise X would apply a 30% price decrease for all surveying services. Thus, decreasing the revenue by 30%, while having

an ability to compete for individual clients. Nevertheless, it is more important that the costs would decrease staggeringly by EUR 280,000 monthly, thus, the yearly balance almost doubles in Option 2.

The financial analysis and especially the cash flows demonstrate that this change is needed, since it is beneficial from the financial point of view. The current system could be preserved if the market would be predicted to flourish in the future, while if the forecasts are doubtful, fewer costs are definitely better.

### **Conclusions and proposals**

When analyzing primary and secondary data and taking into consideration the market characteristics, several conclusions can be made:

- the enterprise X should be restructured to increase profitability, as restructuring would significantly decrease the costs. Therefore, even if the market situation worsens, profitability will be stable. The restructuring must be done with a franchise system, as it would decrease the costs significantly and make the enterprise X more flexible. Surveyors as contract micro-entrepreneurs would give the enterprise X the opportunity to adapt to market changes.
- The restructuring must emphasize surveyor motivation. Surveyors must be encouraged to take the risk and be a micro-entrepreneur. Firstly, their planned salary must be at least by 50% larger. Secondly, conferences must be organized to convince the surveyors about the non-financial gains.
- The enterprise X must reorganize the company and restructure surveyors from employees to contract micro-entrepreneur. Management skill trainings must be organized.
- The enterprise X must ensure that promotion and other services will stay at the same level in order to assure the surveyors with enough work. Surveyors must work with both individual and corporate client.

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### **Kopsavilkums**

Ar 2010.g. 1. septembri Latvijā stājās spēkā „Mikrouzņēmumu nodokļa likums”, kas ļauj maksāt vienoto mikrouzņēmuma nodokli 9 % apmērā no apgrozījuma. Pētījuma novitāte – likuma ietekme nav pietiekoši izpētīta. Pētījuma laika periods ir 2010.–2011.g. Pētījuma mērķis ir atklāt vai izmaiņas likumdošanā ļauj uzņēmumam ar filiāļu tīklu samazināt izmaksas, pārveidojot filiāles par mikrouzņēmumiem. Pētījums ir veikts uz konkrēta Latvijas uzņēmuma piemēra, pārveidojot SIA ar filiāļu tīklu par atsevišķiem mikrouzņēmumiem. Uzņēmums ir SIA, kas darbojas mērniecības jomā kopš 2005.g. un šobrīd tam ir izveidotas 29 reģionālās filiāles. Uzņēmumā strādā 160 darbinieki. Uzņēmuma apgrozījums 2010.g. sasniedza apm. 5 milj. EUR. Kopējais mērniecības pakalpojumu tirgus Latvijā ir 15–20 milj. EUR, tādējādi pētāmais uzņēmums ir viens no līderiem savā jomā. Reģionālās filiāles ir izveidotas nekustāmā īpašuma pirkšanas un pārdošanas plaukuma gados (2005.–2007.g.), kad pieprasījums pēc mērniecības strauji pieauga. Recesijas laikā (2007.–2010.g.), tirgus samazinājās 3–5 reizes. Šai laikā kā uzņēmuma konkurenti parādījās mazie uzņēmumi, kas lielākoties sastāv no 1–2 mērniekiem, kā arī individuālā darba veicēji. Tie oficiāli uzrāda minimālos fiksētos izdevumus, minimālu apgrozījumu un tādā veidā maksā mazus nodokļus. Krīzes dēļ tirgus saruka, individuālie klienti praktiski pazuda, un uzņēmumam, lai nezaudētu Latvijas lielo uzņēmumu „Latvenergo”, „Latvijas Meži”, „Latvijas Dzelzceļš” u.c. pasūtījumus, ir jāmeklē veidi kā samazināt savas izmaksas. Viens no veidiem – pārveidot filiāles par mikrouzņēmumiem. Lietotās pētījuma metodes: finanšu dokumentu analīze, PEST analīze, intervija ar uzņēmuma izpilddirektoru un darbinieku intervija. Ir veikts uzņēmuma ieņēmumu un zaudējumu aprēķins un sastādītas divas atšķirīgas naudas plūsmas gadījumā, ja uzņēmums strādā ar filiāļu tīklu un gadījumā, ja tas tiek restrukturizēts par mikrouzņēmumiem. Darbinieku motivācija un finansiālie aspekti ir izpētīti slēgta tipa intervijā. Intervija ir veikta elektroniski, lai tajā varētu piedalīties mērnieki no visām uzņēmuma filiālēm. Aptaujāto skaits 70, saņemto atbilžu skaits – 50, līdz ar to aptaujas rezultāti tiek uzskatīti par ticamiem. Pētījuma kopējie rezultāti ir apkopoti secinājumos un priekšlikumos. Tie parāda, ka filiāļu pārveide par mikrouzņēmumiem ļauj palielināt ieņēmumus un samazināt izmaksas, t.i. atbilde uzpētījuma jautājumu ir pozitīva. Aprēķini rāda, ka filiāļu pārveides par

mikrouzņēmumiem rezultātā kopējā uzņēmuma konkurētspēja pieaug, kā arī restrukturizācijas rezultātā palielinās mēriņu motivācija un ieinteresētība rezultātā.