NEW
BUSINESS
START-UP KIT

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CHAPTER 1: STARTING OUT

Business Plan

The business plan is essential to a company's success. It is simply a company's target goals and the steps it will take to reach those goals. The business plan is a tool to facilitate business development initiation and success.

A business plan will provide:

- A route for the company to follow.
- A direction to assist the company in obtaining concrete goals.
- A clear statement that may provide for outside financial assistance (such as aiding bankers in obtaining insight concerning the company).
- Communications of goals for: marketing, operations, manufacturing, etc.
- Concrete guidelines for judging management efficiency, a control tool regarding the company's operations, and a reminder in the future of what the company's intent was.

The essential elements of the plan will encompass the company's:

- Overall Mission
- Specific goals
- Company history
- Products or services
- Market strategy
- Industry
- Company operations
- Steps for implementation
- Time frame for accomplishing goals
- Potential risks and problems to be overcome
- System for evaluation of plan and re-direction

Vision Statement

Creating a vision statement is the first step in planning. It clearly outlines what your business is all about. A simple way to develop a vision statement is to try to answer these questions:

- Who is my primary customer group?
- What do I contribute most to my primary customer group?
- In my customers' eyes, what do I want to be famous for?

Marketing

Marketing is an organized approach using many different tools. Your vision statement and business plan will drive your marketing effort. What works for one company may not work for you.

Jay Conrad Levison in Guerilla Marketing Excellence says there are 100 “weapons” for small businesses. Here are some examples:

1. Use a marketing calendar – Plot the use of your weapons for the entire year.

2. Step back and look at your business from your customer’s point of view.

    - Are your hours of operation customer friendly?
    - Is your business flexible? Can you adjust to meet market demands?

3. Do you look for opportunities to upgrade:

    - “Mine” current client base if not for business… for referrals
    - Enlarge the size of each transaction

4. If appropriate, use fusion marketing techniques. Join forces with another firm that offers a complimentary product or service.

5. Follow up; sixty five percent of all business is lost after the sale.

    - Immediately after the sale – send a thank you note.
    - Two – three months after the sale send a follow up letter offering another product or service.
    - Six months later send a letter asking for the names of three other people with whom you should be doing business.
    - Nine months later send a customer survey.

6. You are your own BEST marketing weapon… market, market, market.

7. Advertising is $1/100^{th}$ of the marketing program. Use advertising in conjunction with other tools like direct mail, seminars, trade shows… whatever works for your industry.

Financial Fitness Tip: Use the Santa Barbara News Press for free advertising

CHAPTER 2: SELECTING A LEGAL ENTITY

One of the first major decisions you will have to make as you start your new business is the form of legal entity it will take. To a large degree this decision may be dictated by the way you have organized your operations and whether you intend to work on your own or in conjunction with others.

The form of entity you choose can have a significant impact on the way you are protected under the law and the way you are affected by income tax rules and regulations. There are five basic forms of business organizations. Each has its own benefits and drawbacks and is treated differently for legal and tax purposes.

Sole Proprietorship

A sole proprietorship is typically a business owned and operated by one individual, or very often by a husband and wife. A sole proprietorship is not considered to be a legal entity under the law, but rather is an extension of the individual who owns it. The owner has possession of the business assets and is directly responsible for the debts and other liabilities incurred by the business. The income or loss of a sole proprietorship is combined with the other earnings of an individual for income tax purposes.

A sole proprietorship is the easiest form of business to own and operate because it does not require any specific legal organization, except of course, the normal requirements such as licenses or permits. A sole proprietorship typically does not have any rules or operating regulations under which it must function. The business decisions are solely the result of the owner's abilities. If the business is run under a name other than the owner's, a fictitious business name statement must be filed with the County Clerk's office.

Please remember to open a separate business checking account. Your personal expenses should be paid through your personal account and business expenses through the business account. The IRS looks with skepticism upon taxpayers who mix and muddle business and personal transactions.

Partnerships

Partnerships can take two legal forms, general or limited. In a general partnership, two or more individuals join together to run the business enterprise. A partnership must usually file a fictitious business name statement to operate a business under the partnership name. Each of the individual partners has ownership of company assets and responsibility for liabilities, as well as authority in running the business. The authority of the partners, and the way in which profits or losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of each of the partners for settlement of partnership debts.

A limited partnership is comprised of one or more general partners who are personally liable for partnership debts and one or more limited partners who contribute capital and share in the profits or losses of the business. The limited partners do not take a part in running the business and are not liable for the debts of the partnership.

The rights, responsibilities, and obligations of both the limited and general partners are typically detailed in a partnership agreement. It is a good idea to have such an agreement for any partnership, whether limited or general.

A partnership is a legal entity recognized under the law and as such it has rights and responsibilities in and of itself. A partnership can sign contracts, obtain trade credit, and borrow money. When a partnership is small most creditors require a personal guarantee of the general partners for credit.

A partnership is also required to file income tax returns for both Federal and state purposes. A partnership typically does not pay income tax; the information from the tax return is combined with the personal income of the partners to determine the overall tax liability

Corporation

A Corporation is a separate legal entity, which exists under the authority granted by state law. A Corporation has substantially all of the legal rights of an individual and is responsible for its own debts. It must also file income tax returns and pay taxes on income it derives from its operations. Typically, the owners or shareholders of a corporation are protected from the liabilities of the business. However, when a corporation is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded the owners of a corporation can far outweigh the additional expense of starting and administering a corporation.

A Corporation must obtain permission from the Secretary of State to use or do business under a fictitious name. A Corporation must also adopt and file articles of incorporation and by-laws which govern its rights and obligations to its shareholders, directors, and officers.

Corporations must file annual income tax returns with the IRS and the California Franchise Tax Board and possibly other states in which it does business. The elections made in a corporation's initial tax returns can have a significant impact on how the business is taxed in the future.

Incorporating a business allows a number of other advantages such as the ease of bringing in additional capital through the sale of equity, or allowing an individual to sell or transfer their interest in the business. It also provides for business continuity when the original owners choose to retire or sell their interest.

Should you decide to incorporate your business venture, you should seek the advice of competent legal counsel and business oriented accountants.

S Corporations

An S Corporation is similar to a regular corporation with some exceptions. For Federal income tax purposes, an S Corporation will pay no tax. For California tax purposes, a 1.5% tax is assessed on net income. The net income or net loss from the S Corporations tax returns is combined with the other income of the stockholder on his or her personal tax return. There are special rules governing the deductibility of S Corporation losses. In addition to this tax issue S Corporations also differ from regular corporations due to some restrictions regarding what types of entities can own an S Corporation and what types of shares an S Corporation can issue.

S Corporation status is attained by timely filing Form 2553 with the IRS and form 3560 with

California. The decision to elect S status is not always an easy one. Careful consultation should be obtained prior to incorporation for new businesses or before filing the election for existing corporations.

Limited Liability Company/Limited Liability Partnership

A limited liability corporation (LLC)/ limited liability partnership (LLP) is another form of business organization that combines the liability protection of a corporation with the favorable tax treatment of a partnership.

An LLC is an incorporated business organization that generally protects all owners against individual liability for the organization's liability and obligations, and against vicarious liability for the negligence and malfeasance of others involved in the business. Management may be flexibly structured to allow members to apportion management authority in the manner they determine the most appropriate. Partnership classification is assured under some state statutes, and may be attained through proper structuring in others.

Most LLCs will have limitations on the transferability of the interest of its members and the ability of members to carry on the business after any member ceases to be involved in the LLC through death, retirement, withdrawal or expulsion. Under the more flexible state statutes, these limitations may be reduced or eliminated through careful drafting of the articles of organization.

Creating an LLC is as simple as forming a corporation. The organization must file **Articles of Organization** with the Secretary of State. These are similar to the articles of incorporation used to form corporations. The filing fees are much the same.

An operating agreement defines the rights and obligations of the members, including how profits, losses, and distributions will be shared among the members.

Members are not personally liable for the debts and obligations of the LLC. The only individual liabilities the members have are for (1) the amounts the members have agreed to contribute to the LLC, (2) under some statutes, amounts distributed to the members, and (3) any negligence or malfeasance the member individually commits or that the member supervises. This generally means that members are not liable for the contracts and general liabilities of the LLC or for any mistakes or improper actions of others in the name of the LLC.

One of the greatest advantages of forming an LLC is its tax structure. If properly structured, LLCs provide the benefit of one level of taxation; therefore, as with partnerships, any income generated by the company is passed through to the tax return of the owner. Owners do not avoid personal taxes; but corporate taxes are avoided.

Businesses that may benefit from LLC status include small groups of real estate investors, sole proprietor who want to take in investors and offer them limited liability, farmers, small manufacturers, retailers and service businesses. However, in some cases, it may be less cumbersome and less expensive to purchase limited liability insurance and operate as a sole proprietor.

Businesses that may not benefit from LLC status are businesses with high gross income and low net income (due to California tax on gross receipts), businesses where members want to take advantage of tax-free employee benefits, and sole proprietorships who don't want additional paperwork or to share their business with someone else.

Professional service providers (doctors, lawyers and accountants) are not allowed to operate as an LLC, but may operate as an LLP, a limited liability partnership.

CHAPTER 3: REGISTERING WITH THE TAX AUTHORITIES

A significant task for the new business owner is assuring that the business is properly complying with the extensive tax and information filing requirements imposed by various governmental agencies. Stiff penalties are commonly assessed if the required forms and returns are not properly prepared and timely filed. There are several forms required to be filed when the business is started. While this chapter is not intended to be an all inclusive list of the filing requirements, it summarizes some of the more prominent requirements common to most businesses. Many industries have specific filing requirements which are not part of this text, but which nevertheless, must not be overlooked. Professionals with experience in your industry should be consulted to assure that any such filings are properly handled.

Internal Revenue Service

All tax forms filed with the Internal Revenue Service require the use of a Federal Employer Identification Number (FEIN). This number is obtained by filing a Form SS-4 with the Internal Revenue Service. An example of Form SS-4 is in the Exhibit Section.

There is no deadline for filing Form SS-4. However, to avoid substantial confusion, file your Form SS-4 early. If an income tax form is filed without a FEIN, the Internal Revenue Service will assign one. It is not uncommon for the Internal Revenue Service to assign more than one FEIN to a business, which can result in notices for delinquent tax returns that have been filed using a second FEIN.

Most filings with the Internal Revenue Service come under the headings of income and payroll taxes. Payroll tax requirements are detailed in Chapter Five. Income tax filing requirements and tax planning are discussed in Chapter Seven.

License Requirements

Business License

To operate a business you must obtain a business license. Applications can typically be obtained at the city hall where your business is located. At the time of filing the application, a fee must be paid which can range from $25 to $25,000 depending on the city and the size of the business. The license is issued immediately and must be posted in plain sight at your place of business. The license, with the related fee, must be renewed annually.

City of Santa Barbara	735 Anacapa Street (De la Guerra Plaza) Santa Barbara	 564-5346
County of Santa Barbara	105 Anapamu Street, Room 109 Santa Barbara	 568-2920

If you have a commercial location in the city limit, or you come into the city to deliver products or service, you need a city license. You need a County business license if you are doing business in the county but don't operate out of a fixed commercial license in the County. See samples of forms in the Exhibit Section.

Home Occupational Permits

If you are working out of your home, you may need a Home Occupational Permit and a zoning clearance from S.B. County Resource Management (123 E. Anapamu Street, Santa Barbara) See forms in the Exhibit Section.

Telephone Solicitor's License

If you sell your products door to door or do a large part of your sales on the phone, you need a solicitor's license. See form in the Exhibit Section.

Fictitious Business Name

If you are a sole proprietor doing business in a name other than your own or are operating as a partnership, you must file a Fictitious Business Name statement with the Santa Barbara County at the County Clerk's office (568-2265). You have 40 days from the time you open to file the paperwork. The cost is $33 for the first name and $6 for every subsequent name, and is good for five years.

You must run an ad in an adjudicated newspaper for 4 consecutive weeks within 30 days of the time you start the business. The paper will send an affidavit to the county Clerk's Office. At the County Clerk's office, you can check the microfiche to see if the name you have chosen is in use within the County. You can check statewide by calling the Secretary of State, if you are a corporation. Nationally, check with the Commerce Department.

Tax Calendar

The following summarizes some of the more significant filing dates for a corporation using a calendar year-end. Many of these requirements also apply to partnerships and sole proprietorships. Naturally, if a year-end other than December 31st is used (see Chapter Six) some of these dates will vary.

DATE	***RETURNS***
January 31	Year end payroll tax returns Sales tax return* Quarterly payroll tax returns Annual Form W-2s issued to employees Form 1099s issued to payees
February 28	Form W-2s filed with Social Security Administration Form 1099s and 1096s filed with IRS
March 15	Corporate income tax returns Partnership & LLC income tax returns
April 15	Estimated income tax payments Individual income tax returns
April 30	Quarterly payroll tax returns
June 15	Estimated income tax payments
July 31	Quarterly payroll tax returns
September 15	Estimated income tax payments
October 31	Quarterly payroll tax returns
November – December	Year-end tax planning
December 15	Estimated income tax payments

There are also numerous other tax filing deadlines if you deal in certain regulated industries such as utilities or petroleum.

* Larger companies may have to file sales tax returns on a monthly, quarterly or semi-annual basis.

IRS Publications

The Internal Revenue Service publishes some useful handout materials. We have provided you the form for ordering the publications (or you can pick up at the IRS office, 1332 Anacapa Street). The order form has only the form number listed, so the following may be useful information:

- Taxpayers Starting a Business - PUB 583
- Business Use of your Home - PUB 587
- Tax Guide for Small Business - PUB 334
- Business Expenses - PUB 535
- Business Use of a Car - PUB 917

CHAPTER 4: ACCOUNTING AND BOOKKEEPING

Most operators of a new and growing business have a flair for the environment in which the business operates. They may be a great salesperson, an outstanding mechanic, carpenter, lawyer, or inventor. Unfortunately most people don't like to keep the books. As an owner of a business, you must remember that your company's books and financial statements represent a score sheet. This score sheet tells how the business progressing, and also acts as an early warning system to let you know when and why the business may be going amiss. Financial statements, and the underlying records, will provide the basis for many decisions made by outsiders such as banks, landlords, potential investors, and trade creditors as well as taxing authorities and other governing bodies. The necessity for good, well organized financial records cannot be over-emphasized. Some of the greatest mistakes made by owners of small businesses are not keeping good financial records and making improper or poor business decisions based on inadequate information.

Quality financial information does not necessarily translate into complicated bookkeeping or accounting systems. Far too often owners of businesses become overwhelmed by their accounting system to the point where it is of no use to them. An accounting or bookkeeping system is like any tool used in your business; it needs to be sophisticated enough to provide the information you need to run your business and simple enough for you to run it (or supervise the bookkeeper). Questions you should ask in developing an accounting and financial reporting system are:

1. Who will be the users of the financial information?

2. What questions do I need answered to manage the business?

3. What questions should be answered for government or regulatory taxing authorities?

As your business grows, you should work closely with your accountant to ensure that your accounting system is providing you with appropriate information.

Chart of Accounts

The basic road map into any accounting system is the chart of accounts. It is this chart which helps establish the information that will be captured by your accounting system, and what information will subsequently be readily retrievable by the system. This tool, like the rest of the accounting systems, needs to be dynamic and should grow as the size and needs of your business changes.

To help establish a good working chart of accounts, you need to answer some questions. In conjunction with your accountant, determine how your business will operate, and what is important to you. Some of these considerations might be:

1. Will your business have inventory to account for? If so, will it be purchased in final form or will there be production costs?

2. Are fixed assets a significant portion of your business?

3. Will you sell only one product or service or will there be several types of products and/or

services?

4. Will you have accounts receivable from customers which you will need to track?

5. Are you going to sell in only one location or will you do business in several locations?

6. Are the products you sell subject to sales tax?

7. Do you need to track costs by department?

8. What type of government controls or regulatory reporting are you subject to?

Each one of these questions can have several answers and will probably generate more questions. Each answer will have an impact on how the chart of accounts is structured. It may seem that developing a chart of accounts is not particularly high on your list of things to do as you start a new business, but the amount of time and money that a well organized accounting system may save you can be significant. Especially as the need to generate more information for various purposes increases. An example of a basic chart of accounts follows this section.

Cash or Accrual Accounting

One of the decisions to be made as you start a business is whether to keep your records on a cash or accrual basis of accounting. The cash basis of accounting has the advantage of simplicity and almost everyone understands it. Under the cash basis of accounting you record sales when you receive the money and account for expenses when you pay the bills. The increase in the money in "the cigar box" at the end of the month is how much you made.

Unfortunately, as we all know, the business world is not always so easy. Sales are made to customers and you sometimes must extend credit. Your business will incur liabilities which are due even though you may not have received the invoice or have the cash available to pay them. Most users of financial statements such as bankers and investors are accustomed to accrual basis statements and expect to see them. Once you become familiar with them, they provide a much better measuring device for your business operations than cash basis statements.

Under the accrual method of accounting, income is recognized when earned (whether cash is exchanged or not). This method involves more record keeping. You must keep track of what people owe you (Accounts receivable), and what you owe (Accounts payable).

See worksheet for calculating net income on both the cash basis and accrual basis.

Financial Fitness Tip: Accrual books, cash basis taxes.

Whether you use the cash or accrual basis, it is possible to keep books for income tax purposes on a different basis than for financial statements. It may be more advantageous (less tax) for you to do so. Your accountant can advise you on the advantages and feasibility of doing this in your particular circumstances.

Accounting Records and Record-Keeping

Other questions which the owner of a business must answer are "Who will keep the books of the business? Will you do it yourself? Will the receptionist or a secretary double as a part-time bookkeeper? Will you have a bookkeeper that comes in periodically, or will the volume of activity be such that a full-time bookkeeper will be required?"

Very often the owners of a business decide to keep the books themselves and underestimate the amount of time and commitment this requires. As a consequence, the record-keeping is often low priority and must be caught up later. This approach, though rarely planned, can require a substantial expenditure of time and money. While it is important for the owners of a business to maintain control and stay involved in the financial operations of the enterprise, this can be achieved by maintaining close control over the check signing function and scrutinizing certain records. Your company's accountant can help develop a good program of record keeping duties for you, your employees, and any outside bookkeepers you may engage.

<u>Financial Fitness Tip:</u> The owner should develop the chart of accounts with the assistance of their accountant or a qualified bookkeeper. Palius + O'Kelley can provide you a bookkeeper, through Central Coast Bookkeeping and Tax.

There are a number of very good, easy to use accounting software systems which are commercially available, but none of them will solve the problems of inaccurate or poor quality financial records. All they will do is generate bad information faster. When using accounting software, either in your own business, with a service bureau or through your accountant, it is imperative that you generate accurate information to be entered into the system.

<u>Financial Fitness Tip:</u> Computers are also great to track, measure, and manage non-traditional functions such as number of referrals, prospects and sales your team can generate. Also don't forget desk top publishing for newsletters and communications.

Internal Control

What is internal control? It is the system of checks and balances within a business enterprise that helps to ensure that the company's assets are properly safeguarded and that the financial information produced by the company is accurate and reliable. When you're operating as a "one man shop," or at least handling all of the company's financial transactions, maintaining good internal accounting control is relatively straight forward.

However, when your company grows to the size where you must delegate responsibilities, it becomes more difficult to ensure that all the transactions are being accounted for properly.

No matter the size of your business, you should always be able to answer "yes" to the following questions:

1. When my company provides goods or services to our customers, am I sure that the sale is

properly accounted for and recorded in accounts receivable or the cash is collected?

2. When cash is expended by my company, am I sure we received goods or services?

The methods used to ensure that these two questions can be answered affirmatively will vary widely. The solution in your particular instance may be as simple as numbering the sales tickets and being sure *all tickets are accounted for* or reviewing all invoices and timecards before signing company checks. These are fundamentals in a well run business. As the company grows you will need to consider concepts such as segregation of authority as well as employee fidelity bonds or controlled access storerooms. These are essential stepping stones to maintaining good control in your business.

No matter what the size of your enterprise, you should consider controlling your business and safeguarding hard earned assets as a priority *from the outset*.

Illustrative Chart of Accounts

Current Assets:

1000	Cash
1120	Accounts Receivable
1130	Inventory
1140	Prepaid Rent
1150	Prepaid Expenses

Furniture, Fixtures and Equipment:

1310	Equipment
1320	Furniture and Fixtures
1330	Automobile
1340	Leasehold Improvements
1350	Accumulated Depreciation

Intangible Assets:

1410	Goodwill
1420	Organizational Costs
1430	Accumulated Amortization
1440	Deposits

Current Liabilities:

2100	Line of Credit
2110	Accounts Payable
2120	Interest Payable
2130	Salaries Payable
2140	Income Tax Payable
2150	Sales Tax Payable

Payroll Taxes Payable:

2160	Federal Withholding and FICA Tax Payable
2170	State Withholding Tax Payable
2180	Federal Unemployment Tax Payable
2190	State Unemployment Tax Payable
2200	Advances from Customers

Long-Term Liabilities:

2400	Notes Payable

Owner Equity:

3500	Capital Stock
3600	Retained Earnings
3610	Owner's Draw or Distribution - This account can be used for all entities except for a corporation.

Revenue:

4000	Sales
4100	Returns and Allowances

Cost of Goods Sold:

5100	Purchases
5110	Freight
5120	Direct Labor

Expenses:

6010	Advertising
6020	Bank Charges
6030	Contract Labor
6040	Depreciation and Amortization
6050	Dues and Subscriptions
6060	Employee Benefits
6070	Insurance
6080	Interest Expense
6090	Janitorial
6100	Legal and Professional Fees
6110	Meals and Entertainment
6120	Office Expense
6130	Payroll
6140	Postage and Shipping
6150	Rent
6160	Repairs and Maintenance
6170	Supplies
6180	Taxes – Income
6190	Taxes – Payroll
6200	Taxes – Other
6210	Telephone
6220	Travel
6230	Utilities

Other Revenue:

7010	Interest Income
7020	Other Income

CHAPTER 5: PAYROLL AND SALES TAXES

Irrespective of the form of business in which you operate, if you are going to have employees then you will have to contend with payroll taxes. The brief summary which follows will give you some guidance in the rules and regulations of the various taxing authorities.

<u>Financial Fitness Tip:</u> The payroll tax law is extremely complicated and the penalties for late or incorrect filing are very high. We strongly recommend that all businesses with three or more employees use a payroll tax service. We can refer you to a reputable and economical service.

Employees vs. Independent Contractors

New business owners often ask if they can hire people on a part time, contract basis. The answer is yes and no! Because the IRS would like all employees to pay tax on a regular basis, they like to see personnel classified as employees. Business owners who want to save employer only taxes would like to see personnel classified as "contractors." Therefore the IRS has provided employers with a "look and feel test." See the following for details.

Federal and State Payroll Deposit Requirements

All employers are required to use the federal employment tax deposit rules that were effective 1/1/08. Please refer to Circular E, Publication 15, Employer's tax Guide, covering payroll tax reporting and deposit requirements. This publication is available at the local IRS office, online, or at www.irs.gov.

Supplemental Wages

If supplemental wages – such as bonuses, commissions, overtime pay – are included in the same payment with regular wages, tax to be withheld is determined as if the total of the supplemental and regular wages were a single payment for the regular payroll period.

If supplemental wages are not paid with the same payment as the regular wages, the employer may:

1. Withhold at a flat rate of 25% for Federal and 6-9.3% for California, depending on the type of compensation.

2. Combine the supplemental wage with the last regular wage, determine the tax on the total wage, and subtract the amounts already withheld on the regular wage payment.

Fringe Benefits

Gross income does not include fringe benefits that qualify for exclusion, as described in the categories listed below. Fringe benefits that qualify for the exclusion are exempt from income tax and Social Security tax withholding (FICA and payment of Federal Unemployment Tax

(FUTA)). Conversely, benefits which do **not** qualify are subject to these taxes. An example of a common non-qualifying benefit subject to tax is the automobile allowance.

No-additional-cost service: This is a service provided to an employee that is excludable if the service is offered for sale to the public in the ordinary course of the line of business of the employer in which the employee is working and the employer does not incur substantial additional cost. For example, employers who furnish airline travel or hotel rooms to employees working in these lines of businesses in such a way that the non employee customers are not displaced and they incur no substantial additional cost in providing those services to the employees, the cost is excludable from the employee's gross income.

Qualified employee discount: Any employee discount is an excludable qualified employee discount if: (1) in the case of property, it does not exceed the gross-profit percentage of the price at which the property is being offered to customers; (2) in the case of service, it does not exceed 20% of the price at which the service is being offered.

Working condition fringe: Any employer-provided property or services are excludable benefits to the extent that they are deductible as ordinary and necessary business expense had the employee paid for them. Under certain conditions, the fair market value of a qualified automobile demonstration used by a full time auto salesperson is an excludable working condition fringe.

De minimis fringe: Property or services not otherwise tax-free are excludable if their value is so small as to make accounting unreasonable or administratively impractical. An operation of any eating facility for employees is an excludable de minimis fringe if it is located on or near the employer's business premises and the revenue derived normally equals or exceeds the direct operating costs of the facility.

Qualified Moving Expenses Reimbursement: An employee may exclude from gross income an amount received from an employer for payment of qualified moving expenses.

Transportation Fringe Benefits: Beginning in 1995, an employee may exclude from gross income certain maximum amounts received from an employer as reimbursements for transit passes, vanpooling expenses, and qualified parking expenses.

Other Tax Requirements

Whenever a wage payment is made, the employer must provide the employee with a statement of the gross wages and specific deductions (if any). Use the Form W-4 submitted by the employee and the tax tables provided in the employer's tax guides to determine the correct income tax to withhold. If the employee fails to submit a Form W-4, the employer must withhold at the rate applicable to a single person who has no withholding exemptions. A continuing requirement exists for employers to submit, with their quarterly payroll tax returns, a copy of any Form W-4 on which an employee is claiming an equivalent of 10 or more withholding exemptions.

An employer must also complete a Form I-9 on each employee and obtain the necessary citizenship or other employment eligibility status verification.

When making a reimbursement or payment of moving expenses to or for an employee, the employer must complete and furnish the employee with a Form 4782 for each move.

The employer must also furnish a Form W-2 to each employee showing remuneration and withheld taxes for each calendar year. Flat rate expense account allowance, disability insurance paid by the employer, and moving expense reimbursements are among the items to be included as other compensation on a Form W-2. Upon request, a Form W-2 must be furnished to a terminated employee within 30 days after the request or the final wage payment whichever is later. All other Forms W-2 should be given to the employees by January 31, of the following year.

Financial Fitness Tip: The payroll tax requirements and the work related to compliance are quite cumbersome and complicated. Once a business employs more than a few people, we recommend that a qualified payroll service be used because it has generally been our experience that the cost of the service far outweighs the personnel and management time required to operate the payroll system in house.

Tax Rates

The following charts contain tax rates and the taxable wage basis for employers and employees. The limits and maximum contributions are per employee.

Payroll Taxes	2007	2008
Social Security portion of FICA	6.2%	6.2%
Social Security wage base	$ 97,500	$ 102,000
Medicare tax portion of FICA	1.45%	1.45%
Medicare tax wage base	No max	No max
Maximum Social Security portion of FICA	$ 6,045	$ 6,324
Maximum Medicare portion of FICA	No max	No max
California SDI tax rate	0.6%	0.8%
SDI wage base	$ 31,767	$ 31,767
Maximum SDI withheld	$ 254	$ 159
FUTA tax rate	0.8%	.08%
FUTA wage base	$ 7,000	$ 7,000
Maximum FUTA tax paid	$ 56	$ 56
SUI tax rate (Voluntary prepayment may reduce annual costs. Calculations must be made to determine desirability.)	Varies by experience	Varies by experience
SUI Wage base	$ 7,000	$ 7,000
Self employment tax (same as SS & Medicare paid by employees X 2	No max	No max

CHAPTER 6: SELECTING A YEAR-END

If the new business is a sole proprietorship or a partnership, the company will usually be required to use a calendar year-end. However, if the business is incorporated, the corporation is often allowed to select a fiscal year-end using a month end other than December.

Which Month to Choose

The selection of a year-end involves several considerations. The most important factor is the ease by which data is accumulated. For this purpose, most companies prefer to use a quarter-end as the last day of the fiscal year (e.g. March 31, June 30, September 30, or December 31). Many companies not using a quarter-end date find that it complicates several government filings and can be confusing to shareholders and others when disclosing quarterly data.

A second consideration involves the nature and seasonal fluctuations of the business. As a general rule, the year-end causes a disruption to the normal course of business, especially if a physical inventory is required. It is usually better to have this disruption occur during the off-season. Also, since the periods just before and just after year-end often involve an additional time commitment by the key officers, a year-end that does not conflict with normal vacation schedules is preferable.

There are also tax reasons to select a year-end other than December 31. If the company has, for example, a June 30 year-end, it is possible for the corporation to pay bonuses in June and obtain a tax deduction. The employee then has six months to decide whether to pay tax currently on the income or attempt to shelter it.

Proper planning in selecting a year-end can also defer the payment of taxes at the corporate level. Suppose the company incorporated in July and operated at break-even through the next April, but expected May and June to be big income months. By selecting a March or April year-end, the company can delay for ten months the payment of taxes on the May and June income. Since cash is often scarce for a start-up company, this deferral can be of significant benefit.

How to Make the Election

The election of a year-end is made on the first tax return of the corporation. Even though the corporate by-laws disclose the fiscal year and the request for Federal Identification Number (Form SS-4) asks for the year-end, a final election is not made until the tax return is filed. There is not a separate form for making the election. The corporation merely states the fiscal year on page one of Form 1120. There are two important requirements for making the election. First, it must be made on a **timely filed** (including extensions) return. If the first return is not timely filed the year-end of the corporation is, by default, December 31. Secondly, the first year can not be longer than twelve months. For example, if a company is incorporated on June 25, and wants to select a June year-end, it must file a return for the five day period, June 25 through June 30. Otherwise, the first return would be for twelve months and five days which is not allowed.

Changing the Year-End

Once a year-end is selected, it may be changed under certain conditions without the prior approval of the Internal Revenue Service. If the conditions are not met, it can only be changed if permission is obtained from the Internal Revenue Service. In considering a request for change of year-end, the Internal Revenue Service will look closely at the business or economic reasons for the change. The absence of a tax avoidance motive is generally a requirement.

Certain corporate events will require a change of year-end. For example, if the company's stock is acquired by another corporation, the acquired corporation will be required to use the same year-end as the parent company.

CHAPTER 7: INCOME TAXES

Eventually you will have to deal with income taxes. The income tax laws are extensive and can be confusing for an individual starting a business. This chapter does not cover all the tax ramifications of a new business, however it provides some guidance on complying with the laws. A qualified CPA or tax attorney should be consulted when you are dealing with income taxes. Income taxes have a direct result and a potentially significant impact on the cash flow of your business.

Income Tax Forms

Each type of legal entity is required to file a different type of income tax form.

Corporation. A Corporation is considered a taxable entity and is required to file a Federal Form 1120 and California Form 100.

Partnership. A partnership is not a taxable entity. It is treated as a conduit through which taxable income is passed to the individual partners for inclusion in their respective tax returns. The partnership is required to file Federal Form 1065 and California Form 565. No tax is due with these forms. However, included with the forms is a schedule K-1 which lists the various items of income and credits to be included on the individual partner's return.

S Corporation. An S Corporation is a type of corporation that is specially treated under the tax laws. The government taxes this type of entity in the same manner as a partnership, with certain exceptions. The tax forms required are Federal Form 1120S and California Form 100S. Included with the forms is a schedule K-1 (see above).

Sole Proprietorship. A sole proprietorship is considered to be a component of the individual's personal tax situation. The tax form required is the Schedule-C which is included with the owner's Form 1040. In addition, if the business has net taxable income, then a Schedule SE must be prepared to determine the amount of self-employment tax that is due. California follows these same rules with the exception of the self-employment tax which is not levied under the California tax laws.

Limited Liability Company. This is a new form of business organization and if properly structured, is treated as a partnership for Federal income tax purposes. For state income tax purposes, the state determines the income tax treatment.

Estimated Tax Payments

In addition to the regular tax forms the law requires that if an estimate of the tax is not properly *prepaid* on a quarterly basis, a non-deductible underpayment penalty will be levied. Since an estimate is based on forecasting the future, and liable to human error, the tax laws provide two safe-harbors to avoid the penalty for underpayment. If your payments for each quarter equal the lesser of 100% of the prior year's tax or 90% of the current year's tax, then the penalty can be avoided. In some cases you may have to pay 110% of the prior year Federal tax liability to avoid the penalty. California requires a minimum corporate estimate of $800 *even if there is no tax* owed. Estimates are filed using the following forms:

Corporate Federal tax deposit Form 8109 deposited with your bank.
California Form 100-ES.

Individual Federal Form 1040-ES.
California Form 540-ES.

Due Dates

The due dates of the various Federal and California forms are:

Corporate Federal Form 1120 and California Form 100 are due the 15th day of the 3rd month after the end of the tax year. The Federal tax deposit Form 8109 and California Form 100-ES are due the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

Partnership Federal Form 1065 and California Form 565 are due the 15th day of the 4th month after the end of the tax year (April 15th for most partnerships).

S Corporation Federal Form 1120S and California Form 100S are due the 15th day of the 3rd month after the end of the tax year. Federal tax deposit Form 8109 and California Form 100-ES are due the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

Sole Proprietorship Federal Form 1040 and California Form 540 are due April 15th. Estimated tax payment Forms (Federal Form 1040-ES and California Form 540-ES) are due quarterly on April 15th, June 16th, September 15th, and January 15th.

Limited Liability Company May be classified as a partnership or corporation for Federal income tax purposes. Filing dates also vary by state.

Extensions

The business owner may request an extension of time to file the tax returns. However, these extensions do not extend the time for paying the tax.

First Corporate Return

The first tax return a corporation files is very important. As part of that return elections are made which will dictate the way the corporation is taxed for many years to come. Some of the more significant elections that may need consideration are outlined below:

1. Elect to expense up to $5,000 of Start Up costs

2. Election to capitalize and amortize costs incurred to organize the business. These can be legal, accounting or similar fees paid to commence operations. Such costs are not normally considered expenses of the corporation and are not deductible unless this election is made.

3. Election to accrue vacation pay earned but not taken by employees at the end of the tax year. Without this election, vacation pay is not deductible until the year it is taken.

The elections discussed above are only a few of those that may need to be considered in an initial return. A qualified tax practitioner can help plan how best to utilize elections to take advantage of some of the following provisions of the Federal and California tax laws including:

A. Net-operating loss carryovers
B. Research and development tax credits
C. Business energy tax credits
D. California tax credits

Tax Planning

Proper tax planning is essential in order to make the most of the income tax laws. You will probably need to develop a relationship with a qualified professional who has experience with the taxation of your type of business. Tax planning is not a one-time shot right before the return is due. Tax planning is a year-round endeavor requiring communication on both sides – you and your CPA. Proper planning ensures that there are no surprises when the return is filed.

State Taxes

If your company will be doing business in more than one state, it is essential that you familiarize yourself with the tax laws and filing requirements of those states. Each state has its own rules and regulations; if you are in non-compliance, you may be barred from doing business in that state.

Start-Up and Organization Costs

When you get ready to go into business, you probably will have a number of different costs. These are the costs of setting up an active trade or business, or investigating the possibility of creating or acquiring an active trade or business. For example, you may:

- Travel to look over various business possibilities, or to find customers and suppliers.
- Conduct market surveys, or begin to advertise your business.
- Retain a lawyer to help organize your business, or an accountant to set up a record keeping system.
- Begin to hire and train employees.
- Analyze available facilities, labor supplies, etc.

However, because your business has not yet started active operations, you are not allowed to deduct these kinds of costs as expenses. These costs are "start-up costs" and must be amortized on a straight line basis over 60 months. However you can elect to expense up to $5,000 of your start up costs. The monthly deductions begin in the month you begin business operations. You can therefore only amortize these costs if you actually go into business.

Financial Fitness Tip:
Examples of Income Splitting

Joe and Sue own a retail business that has income of $100,000 per year. Their personal deductions total $25,000. Their total "draw" from the business is $60,000 per year to pay all of their personal bills. They have no other income of any significant amount.

Without addressing California Income Tax or Social Security/Self Employment tax issues, the federal income tax would be:

Scenario #1 - Sole Proprietor	
Individual tax return	
Adjusted gross income	$ 100,000
Total deductions	(25,000)
Taxable income	75,000
Federal income tax	$ 15,930
Scenario #2 – Business is incorporated, Joe and Sue receive a $60,000 salary from the corporation, with The remaining $40,000 corporate profits remaining In the business.	
Individual tax return	
Adjusted gross income	$ 60,000
Total deductions	(25,000)
Taxable income	35,000
Federal income tax	$ 5,250

Scenario #2 – Continued	
Corporate return	
Business profits	$ 100,000
Less W-2 Salary (Joe and Sue)	(60,000)
Taxable income	40,000
Federal income tax	6,000
Total federal income taxes	$ 11,250

Summary:	
Federal income tax - scenario #1	$ 15,930
Federal income tax - scenario #2	11,250
Tax decrease (29.4%)	$ 4,680

Financial Fitness Tip: Income tax laws are quite complicated. The amount you may save by attempting to tackle your own taxes, particularly as they relate to a business, can be greatly overshadowed by the expense you may incur if you make a mistake. This axiom takes on greater significance when the return is for a corporation – especially the first return. However, a far greater consideration than potential mistakes is missing opportunities which may be available to you and your business.

CHAPTER 8: CASH PLANNING AND FORECASTING

CASH IS KING! The life blood of any business is its ability to collect cash and pay bills as well as pay its employees, particularly its owners. Far too often small businesses are profitable, but they do not have enough operating capital to meet their current needs. Consequently, they may be forced to sell out to a stronger competitor, sell a portion of the company to investors at an undesirable price or close the doors, and put the company out of business. None of these alternatives are typically what the owners intended when starting the business.

The ability to forecast cash resources and uses is an art and is by no means a well defined science. None of us have a crystal ball and any cash forecast which is prepared by the management of a company or an outside consultant can be no more than a guess as to when the customers will pay and when your business will pay its obligations. Hopefully, the more effort that is put into cash forecasting the better the educated guess will be and the more accurate the resultant picture of the future operations of your business.

Starting the Analysis

One of the most significant factors to be considered in your cash flow forecast is the volume of sales which will be generated in the period for which you intend to forecast. Your sales forecast must be as fine tuned as possible. It is typically unrealistic to assume that there is a million dollar market for your product in your area and you will be able to capture a specified percent of it. A sales forecast needs to be based upon specific facts. These might include your sales history or the history of similar businesses you have owned or operated or the competition. In your area of industry, what has been the experience of similar operations?

Some of the questions which should be addressed would include what other factions can the owner control such as adding new product lines, deleting unprofitable operations, adding a new salesperson, or terminating one that is not producing to quota? In preparing a forecast, you must also take into consideration items such as the seasonally of your business, the relative state of the economy, and the period over which you forecast.

Obviously your ability to forecast sales for the next month is better than it is to forecast three to five years from now. The amount of detail which must be included in the cash forecast is really a matter of preference. It can be based on per-unit sales extended out by the sales price of each type of unit or an average sales volume per day, week or month for your type of business in its current environment.

Cash Collections

Once you have determined a reasonable level of sales and you are comfortable with the forecast you have made, you must address questions such as: what percentage of my sales are received in cash, and what portion are credit sales for which I will have to carry accounts receivable? For those that are receivable based, how soon is the cash collected? Do I have to wait for customers to pay me or do third parties such as Visa or MasterCard take the customers account and convert it to cash for me with an appropriate discount?

If you are relying on customer payments for collection of receivables you must determine what portion of the receivables will be collected in thirty days, sixty days, ninety days, and thereafter, and what portion, if any, may never be collected. To assume that 100% of your sales will ultimately be converted to cash is probably unrealistic especially considering the current economic environment and the tight cash situations that may face some of your customers.

Other sources of cash may be available in addition to sales. Do you expect to bring in a partner or other investors, or can you borrow money from a bank? When will you receive the cash and how much will you get? Part of your cash flow analysis may be to determine how much investment money or borrowings will be required to operate your business.

Once you are comfortable with the cash receipt side of your business, and the timing of the collections of funds from your sales and other sources, it is necessary to consider the expenses and other cash needs of your business operation.

Disbursements

Certainly if your business entails sales of inventory you will have to purchase the merchandise from others or purchase the component parts and pay employees to assemble it. This may require a significant outlay of cash before the first dollar of sales is generated and received. You should consider how often and in what amount your employees must be paid and when their payroll taxes must be deposited.

Additionally, you need to know the credit trade terms your vendors are willing to advance to you. Do you have to pay for inventory items on a COD basis or can you pay for them thirty or forty-five days after receipt?

What expenses must be paid in order to convert purchased merchandise into saleable inventory? If your production requires utilities to run machines or supplies, such as dispensable chemicals or packing materials that must be purchased prior to the sale of the inventory, you should factor the timing of payment.

In addition to the cost of manufacturing, you should consider whether your production capacity will allow you to generate enough inventory to support the estimated level of sales. If the volume of sales you forecast is above and beyond your ability to produce, then changes in your operating environment must be made to meet the production levels. Will you need additional employees, if so, how much will they cost? Do you have to acquire additional machinery for your shop operations? What is the cost of the machinery and when will you have to pay for it?

Once you have determined the cost of operating your production or service facilities, you need to consider what other expenses you must pay to keep the doors of your business open. You typically will have to pay rent for your office or manufacturing facility. You must consider how much the monthly payment is and when it has to be paid. Ask yourself if there will be other cash requirements such as a deposit on first and last month's rent. If you are opening a new business, you must consider what your cash requirements are to make your facility ready for your specific needs and purposes. Will you have to buy or rent furniture? Will you need to make tenant improvements or pay deposits for utilities and other services?

You also need to consider many of the overhead items and costs to open a new business that will hopefully be one time expenses. This may be attorney's fees for drafting partnership agreements or incorporating your business, the cost to obtain business licenses, authorization from the taxing authorities, setting up an accounting system, stationary costs, and costs of signs or logos.

It may seem like the list of costs and expenses to be incurred is endless. It may even discourage you from moving forward with your business endeavor. However, it is imperative to make the list as detailed as possible to ensure that you have sufficient funds to make your operation ready for business prior to running out of cash. The more detailed the list and the more sufficient information you can provide, the less chance there is of unpleasant surprises as you move down the stream to opening your business.

In addition to determining the amount and volume of expenses and cash outlays you will have to make, it is critical to determine the timing of such payments.

As we have discussed in other chapters, there may be a variety of financing alternatives which are available to you. Most of the start-up costs which you incur can be delayed or deferred until you can generate the cash from your operation to help pay them. This needs to be carefully analyzed and factored into your cash flow analysis. However, a good rule of thumb is to assume that you are going to have to pay your expenses sooner than you think and that you will collect your cash slower than you anticipate. If you work with this attitude, any surprises should be favorable ones.

Cash flow planning is a ***must***! In fact, a business plan is a must, (See Chapter 1). The average business owner spends more time planning a vacation than planning how to run his/her business.

For now, let's stick to cash flow planning.

For a start-up enterprise, the plan should be broken down into three stages: a start-up period; initial product or service to market/customer stage; and the ongoing stage achieved after the product or service has been initially delivered.

The three things a cash flow plan must tell users are:

- How much cash will the business need?
- When will the business need the cash?
- Where will the business get the cash?

Palius + O'Kelley CPA's has available, a user friendly, Windows based software called *UP YOUR CASH FLOW* that is excellent for building such cash flow, profitability, break-even analysis and future balance sheet planning tools. We can offer this software at a substantial savings to our clients and others due to our relationship with the manufacturer of the product. The software is especially good at answering, on a monthly, quarterly or annual basis, the three questions listed above: how much, when, and from where?

Palius + O'Kelley CPA's has periodic seminars or workshops throughout the year where we focus on issues such as *The Four Ways to Grow Your Business*, *Pricing and Profitability*, cash flow planning and a variety of other topics. These workshops are not about taxes or accounting - they are about how to improve the profitability and cash flow of your business.

Please contact us if you would like to be put on our mailing list regarding these training sessions.

CHAPTER 9: OBTAINING CREDIT AND FINANCING FOR YOUR BUSINESS

If you are not independently wealthy and perhaps even if you are, eventually you will probably need to obtain some outside capital for your business. In some instances, you may need to obtain capital for the initial expenses prior to opening your business, the funds you require may be for expansion or working capital during the off season.

Generally business financing can take two forms, debt or equity. Debt, of course, means borrowing money. The loans may come from family, friends, banks, other financial institutions or professional investors. Equity relates to selling an ownership interest in your business. Such a sale can take many forms such as the admitting of a partner or, if you are in a corporation, issuing additional common stock, options or warrants to investors. It is typically a prudent idea to consult with your attorney as there are many significant legal ramifications to such a step.

How Do I Get the Money

Irrespective of the type of financing you need and are able to obtain for your business, the process of obtaining it is somewhat similar. There are several questions that must be answered during the course of raising money for your business. The ability to answer these questions is critical to your success in obtaining financing as well as the overall success of the business. Remember, in raising capital you have to sell the ability of your business to potential investors in much the same way as you sell your product to your customers.

1. **How much cash do I need?** To answer this question you will have to do some serious cash flow planning, which will require estimates of future sales, the related costs, and how quickly you must pay your vendors. You will also have to factor into your planning some assumptions about when you will generate enough cash to pay the money back. However, if you raise cash through equity you probably don't need to pay it back but your co-owners will want to know how the value of the business will grow and how they will benefit through dividends or selling their shares.

2. **What will you do with the money?** One of the most important questions you will have to answer for a potential investor is how the money will be spent. Will you use it for equipment or to hire additional employees or perhaps for research and development for a new improved product? Again, part of the answer on how you spend the money is how it will benefit the company.

3. **What experience do you have in running your business?** One of the primary reasons for business failure is lack of experience and management. You will need to convince your investors that you have the knowledge, experience and ability to manage your business and their money at the level in which you expect to operate.

4. **What is the climate for your type of business and your geographic location?** Few investors will want to put money into your business if you haven't done sufficient "homework" to determine that you have a reasonable chance of success. If your business is based on existing economic or legal conditions which are subject to change in the near future your risk is substantially increased. Even if your business has great potential, if the local economy is sluggish to the point that it can't support your venture, you need to be aware of this before moving ahead.

Once you have developed concrete answers to these and other pertinent questions, you can begin looking for financing. One of the first steps is to determine whether to raise funds through debt or equity. There are positive and negative aspects to each type of capital. The cost to your company of each type of funding is different as is the way in which they are treated for income tax purposes. The interest on borrowed money is deductible by a business for income tax purposes, which reduces the effective cost to your company. Dividends which you might pay on the same investment in stock would typically not be tax deductible by your company. In selling stock there usually is no firm commitment by your company to pay the money back but your stockholder will want and generally will have a legal right to have a voice in the management of your company. When you have made the decision as to which type of financing you think is appropriate to fit your needs, it is probably a good idea to consult with your accountant to discuss alternative types of debt or equity financing available.

Financing Alternatives

Whether you determine that debt or equity financing is the best choice for your company, there are a number of alternative types of financing available. Depending upon the nature of your business the financing may be a combination of debt and equity and may be tailored to fit the specific needs of your company.

In this discussion we will only mention a few of the more conventional methods for a young company to obtain capital, though there are many possibilities. A good business oriented accountant can discuss these and other alternatives in greater detail.

Debt Financing Sources

Banks. The first source of funds which typically comes to mind when borrowing money is a bank. Banks typically lend to small businesses on a secured basis using equipment, inventory or accounts receivable. They will also look to other forms of collateral such as real estate. Bankers want to see a source of loan repayment. The more liquid and readily saleable the assets you have to offer as security the more acceptable they are likely to be to a banker. Loans from a bank may take several forms such as:

1. A line of credit which renews annually and allows you to borrow up to a predetermined maximum as you need it and pay it back as funds from sales and receivables are collected.

2. A short term demand note which is payable in full on a specified date.

3. A term loan for the purchase of a specific asset such as a computer or a machine.

As your relationship with your banker becomes better and your business becomes established, you may consider a long-term (3 to 5 years) loan which will be payable in monthly installments.

Lease financing. In today's business environment it is quite common to acquire equipment through lease agreements. Leasing packages come in a variety of types through many sources. Leasing companies typically will accept a somewhat higher degree of credit risk. They are looking to the value of the equipment for collateral if your business cannot make the agreed upon payments. For this reason, leasing companies generally prefer to finance new equipment of a general purpose nature which can be resold if necessary. Leases often run for a period of three to five years and because of the risk that leasing companies are willing to take, they are somewhat more expensive than commercial bank loans.

Trade credit. A very important source of financing for your company may be from the vendors and suppliers with whom you do business. Many suppliers will originally ask for cash on delivery or, in some instances, they may want payment before starting on your order (depending on the nature of your purchase). Most suppliers will quickly establish trade credit with you once you have gained their confidence by continuing to do business with them and paying as requested. Establishing good relationships with trade creditors is essential. It allows you to use the goods and services in your operations and sell your product to your customers, before you pay for them. The trade credit you build today will be relied upon as you attempt to establish yourself with other vendors in the future. Trade credit terms will vary depending on the type of purchase you make, the supplier's industry, and the industry you are in.

Equity Financing Sources

Equity financing usually means selling a portion of your business. This can be accomplished in a number of ways including the sales of common or preferred stock or stock warrants. Equity sales are usually carefully tailored to meet the needs of both the company and the investor.

Venture capital companies. A venture capital company, or fund, is typically a company that is in the business of taking risks. A venture capital fund is often backed by a group of investors which may be individuals or corporations. The investors are often represented by a management group which evaluates potential investments and manages the existing investment portfolio.

The price of venture capital financing is usually very high when compared to borrowing money from a bank, but it must be remembered that venture capitalists are dealing with much higher risk situations than commercial banks will finance. This cost of venture capital is measured in terms of the portion of your company you must sell to obtain the level of financing you require. A venture capital firm sometimes requires a 300 to 500 percentage return on its investment over a four to five year investment period. While this may seem like an enormously high return, a venture capitalist is in the risk business and the return on a good investment must help offset those companies that do not meet their projections or fail altogether. To determine the price of such financing, a venture capitalist will start with the amount of financing you require and calculate what they must receive at the time the investment will be sold to allow them to achieve the necessary rate of return.

Based upon the operating projections you provide, discounted based on their experience, they will estimate what your company might be worth at the time the investment will be liquidated. This might be at the point of a public offering or a sale to a corporate investor. The last step for a venture capital company in determining pricing is to calculate what percentage of the company they must own to realize the return desired. At this point, the "horse trading" generally begins. As a general rule you will want to retain as much of the ownership of the company as you can. The venture capitalist wants enough ownership to achieve the investment goals and have some control over how the money is spent. This will often be achieved by voting power and representation on the Board of Directors. At the same time a venture capitalist wants to be sure there is sufficient reward in the company for you and your management team to be motivated and achieve the projections in your business plan.

A venture capital company is often managed by an individual or group of individuals with a strong background in business and management. They can often provide depth of experience and management assistance in areas where your management team may be weak. A venture capital group can very often provide contacts and valuable introductions in your industry.

Remember, a venture capital investor becomes a member of your team.

Private individuals. Very often, individuals who are successful in their own right and have accumulated substantial wealth, may be looked to for investment in your business venture. Such individuals may believe that the success of your business may enhance theirs as well as help increase their personal wealth. These individuals, like a venture capital company, very often want to participate in the management activities of your firm and help guide your progress through representation on the Board of Directors. The business acumen and contacts of these individuals can often be a valuable asset of your business. An individual investor can often react to opportunity much quicker than a venture capital firm and typically has only their own interests to serve as opposed to a financial backer or group of investors.

Individual investors can be more flexible in the type of investment structure they can deal with and often have personal, financial and tax motivations to consider.

Financial Fitness Tip: Start up companies should consider the Small Business Loan Fund in order to borrow up to $25,000 with no collateral. You could also ask your banker about a bank loan guaranteed by Cal Coastal, or the Small Business Administration. Feel free to call us for more information.

CHAPTER 10: INSURANCE

Business insurance, like many types of expenditures is one of those items which business owners typically do not like to pay. You must remember that sufficient insurance can be as critical to the success of your business as a good product or service. Without proper insurance you could lose all of the money, time and effort you put into your company. The types and amounts of coverage you purchase must be evaluated on a cost-benefit basis like any other commodity. Your accountant and insurance agent can help you review the amount of coverage you may wish to purchase for various purposes. Usually, you will want to insure against risks which could have significant detrimental impact on your business. This normally would include such items as fire, storm damage, theft, general, and product liability.

Depending on the nature and size of your business, it is often a good idea to self-insure for all or a portion of certain losses. Self insurance can be accomplished by not buying coverage for incidental risks or increasing the deductions on policies which you do buy. Often, raising the deductible can have a very favorable impact on policy premiums. The administrative cost to the insurance company to process small claims is quite high, consequently the rates typically go down substantially if they are relieved of this expense by insuring for losses in excess of a sizable deductible amount. An insurance broker can provide you with comparative costs for various types of coverage with varying degrees of deductible amounts.

Required Policies

Very little insurance coverage is mandatory. The only insurance coverage typically required by law is worker's compensation which covers injuries to employees while on the job. Your insurance agent can explain the required coverage, the rating systems, and help you purchase a policy.

You must also be aware that the terms of your building, office lease or mortgage may require you to carry certain kinds of insurance coverage in specified minimum amounts. If you have leased equipment or have borrowed money from a bank or other lenders, there will usually be insurance requirements in the agreements relating to these transactions. There are many other types of policies which you may wish to consider. The specific coverage provided by each and the related costs can be explained in depth by a qualified insurance broker.

Some of the types of insurance coverage which you might consider for your business are listed below:

Business Interruption. This coverage, as the name implies, covers the loss of revenues your business would generate if you were forced to shut down for reasons beyond your control. While this is obviously valuable insurance, the policy premium must be carefully considered relative to the potential profits your business might lose during a short shut-down of operations.

Employee Fidelity Bond. This type of insurance typically covers the risk of loss from theft by employees. If your business deals in large amounts of cash, negotiable securities, or similar types of assets, you may be well advised to consider this coverage. Certain industries are required to carry this insurance by regulatory authorities.

Umbrella Coverage. This type of insurance covers losses above and beyond the limits of other policies which you carry. Umbrella policies usually pertain to liability of various sorts and are usually valuable if your business or you have a net worth which requires protection in the event of a catastrophic loss.

Insurance is like any other product which you purchase. Before purchasing it you should consult with more than one broker as to your needs for protection. You should discuss insurance needs with acquaintances in the same or related business as yours. Before buying coverage you should check out the reputation of the company that is underwriting the policy. Insurance companies are regulated in California by the Commissioner of Insurance and are licensed to do business in the state. Companies are rated by the A.M. Best Company and such ratings are available through your insurance broker.

<u>Financial Fitness Tip:</u> Consider including yourself in your workers compensation insurance. If you get hurt on the job - you can get some benefits. If you are a sole proprietor or partner, consider applying for state disability insurance. If you get hurt off the job you can also receive some benefits.

CHAPTER 11: SELECTING PROFESSIONAL ADVISORS

Starting your own business obviously entails a multitude of decisions, decisions which can seem overwhelming without the right players on your team. In order to succeed you need to equip yourself with every tool at your disposal.

One of the most cost effective tools you can utilize is the expertise of a specialist. The right accountant, attorney and banker can eliminate a host of problems and potentially costly errors you might make as you build the financial foundation of your successful business.

As any coach can tell you, having a first rate quarterback (you) won't guarantee a winning team without a first rate line of defense. The right accountant, attorney and banker **are** your best defense. Their expertise can help save you money, which in turn can be used to increase profits.

When enlisting the expertise of an accountant and attorney you want a specialist suited to meet your specific needs. You want a specialist who will listen to you. More importantly, you need someone you can and will listen to as they devise strategies to help you succeed.

You want to succeed – and you can. By taking the time to make key decisions and enlisting the right players on your team – you will succeed!

We wish you success and welcome you to the wonderful world of free enterprise.

CONCLUSION

You now have a handy reference guide to starting a business. With it you should be able to successfully handle many of the problems encountered in starting and running a business. Always remember to seek professional advice in areas in which you are not sure. The benefit will far outweigh the cost. Good luck!

EXHIBITS