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An
AICPA Personal Financial Planning Section
member benefit

Points to Consider When Starting a Business

Valuation help

The following organizations can help value an existing business:

CFA Institute: 800-247-8132

Institute of Business Appraisers: 800-299-4130

Institute of Management Accountants: 800-638-4427

American Institute of CPAs: 888-777-7077

American Society of Appraisers: 800-272-8258

Starting a Business: Existing, Franchise, or Start-up?

You're fed up with the traditional work grind and have committed to striking out on your own. Or perhaps you have a burning idea for the Next Big Thing and you're itching to get it launched. Or maybe you've stumbled upon an opportunity to be the master of your own destiny, and you simply can't pass it up. Whether you're considering buying an existing business, investing in a franchise, or launching a start-up, you'll want to familiarize yourself with the risks and potential rewards. No matter which option you choose, owning your own business can result in the ultimate benefit of professional and financial freedom.

Buying an existing business

Buying an existing business has certain advantages. First, it has an established product or service, as well as supporting operations. Second, it comes with a track record, including financial statements, that you can examine to gauge its past success. Third, the business will hopefully have established "goodwill," the intangible value of a well-respected business. Goodwill is typically measured by how much is added to the value of a business beyond the actual cost of its assets.

And lastly, another advantage is the management team, who already have experience running the business. If you have questions as you adjust to your new role, these team members may be able to provide valuable guidance. In fact, it is not unusual for the previous owners to stay on for a period of time to assist with the transition and make introductions to clients, helping to maintain goodwill through the transition.

On the other hand, there are some disadvantages to buying an existing business. Often, businesses go on the market because they do not have successful track records, and their current owners are simply trying to unload a burden. This is why it pays to do a significant amount of due diligence while investigating a potential purchase, beyond the financial statements.

Investigate a company's level of goodwill--or possible lack thereof. Ensure that physical assets and technology are sound and up to current standards. Observe the overall culture: Do the employees act as though they enjoy coming to work? Or do they seem unhappy or suspicious? Do they seem free to speak their minds?

Once you've made the decision to purchase a business, the next steps will be to determine its value and structure and negotiate a deal. Business valuation can be extremely complex, so it may benefit you to engage the help of a professional appraiser. There are several organizations that can help you find a qualified appraiser (see sidebar). You'll also need assistance in structuring and negotiating a deal. Consider seeking the advice of both an attorney and a financial professional with business acquisition experience.

Franchises

If you would like to start a new business but not dream up a brand-new idea, a franchise may be the right move. Though certainly not simple, franchising offers the opportunity to own a business with a proven method of operation and a familiar name and trademark. Moreover, when you buy a franchise, you also buy marketing support, business strategy, and assistance with site location (if it's a retail operation).

Other advantages may include established goodwill, greater purchasing power (because your business is part of a much larger organization), and assistance in finding the funds needed to finance the business.

However, franchising also has drawbacks. For example, you likely won't have the final say in all decisions, because franchisors typically retain rights to ensure that your business is run their way. Also, in addition to a one-time franchise fee, franchisors typically charge royalty fees--required regular payments that are typically a percentage of your weekly or monthly gross income.

As with purchasing an existing nonfranchise business, it is very important to thoroughly investigate the company before investing in a franchise. Remember, you are doing more than just buying the rights to use a name--the franchisor is going to be your business partner. Make sure that he or she doesn't want to simply collect your fees and then move on to the next potential buyer.

Franchisors are required to disclose lots of information to potential franchisees, so be sure to do your homework. Talk not only with successful franchisees but also with those who have failed. If several former franchisees tell you that the company didn't fulfill the promises of the franchise agreement, take

note of this red flag and then consider taking your resources elsewhere.

Make sure every representation is made to you in writing before you purchase. Take notes of everything said to you and have the franchisor sign off on them. That way, you will have a record of what was represented if things go wrong.

Start-ups

If you are planning on building your business from the foundation up, just be sure you are ready. This move can be a much bigger risk than buying an existing business or a franchise. Existing businesses and franchises have some operating history that you can use to gauge the potential success of the business. By comparison, with a start-up business, while you naturally think that you will succeed, there are many obstacles to overcome.

Many successful start-ups don't actually begin with a new, innovative product. Instead, they often begin with a proven product or service and launch competing operations, becoming innovative after the new venture has generated a base level of profit and success.

Because your start-up has no previous track record (even if you have had success in your field), you first need to raise enough capital to make a go of it. Because banks or investors will want to see a plan of attack before they will approve a loan for your start-up, your first step should be to create a strong business plan (see below).

Different paths to the same result--professional freedom

No matter which path you choose--buying an existing business, investing in a franchise, or launching a brand-new venture--each requires a significant amount of hard work and commitment. But for many successful entrepreneurs, the professional freedom is worth every bit of the effort.

For more information on creating a business plan, visit the Small Business Administration web site at [sba.gov.](sba.gov)

A Business Plan Can Be a Roadmap to Success

One of the most important steps you can take in launching a new business is creating your roadmap. A carefully crafted business plan captures your vision for your new venture and paints a picture of it for others, including advisors, potential investors, and your management team.

Components of a typical business plan

Cover page and table of contents

The cover page is simply a title page for your business plan document. It should include the name of the company, address, phone number, owners' names, and contact information. It should also include the date on which the document was finalized and published. The table of contents helps readers navigate through the document and identifies page numbers for each of the sections.

Executive summary

The executive summary is essentially your elevator pitch--an abridged version of the business plan that describes to readers why your business is worthy of their attention and possibly their money. It should be no longer than one page, but should contain all pertinent details. For this reason, it is often easier to write this section last.

An executive summary should answer readers' primary questions--e.g., are you looking for funding, is the document a strategic guidebook for management and advisors, or both? As you draft your executive summary, keep in mind that many readers will decide whether the subsequent pages are worth reviewing based on this important section.

Business description

The business description is the first major section of your business plan and should provide more details on the nature of your business. One point should outline the key elements of your business, and subsequent paragraphs might expand on each. The elements should include the following:

Product or service description: Describe in detail the product sold or service provided. If you are producing a product, explain how the product is manufactured. What materials are used? Who are your suppliers? What are the costs of production? If you provide a service, describe what it is and why it is different. How will it be provided? In this section, you might also address potential pitfalls and how they will be addressed. For example, if demand for your product or service is higher than expected, how will you manage the volume?

Legal structure: Business entities come in a

wide variety of legal structures, ranging from sole proprietorships and partnerships to corporations. Each has its own pros and cons. In this section of the business plan, you'll need to describe the entity you selected and the reasons for your decision. Include supporting documentation (e.g., a partnership agreement).

Business and industry description: Who are your key advisors and managers, and how does their experience benefit your organization? Where are you located and why did you choose this location? You might also want to use this section to describe the genesis of your business--i.e., how and why you decided to launch the venture. Provide details on the industry you are in and why your business has a competitive edge. Include relevant data and illustrations, if applicable. (For example, a retail establishment might include a map highlighting strong traffic patterns in the area.)

Market analysis and marketing strategy

Perhaps the most influential section of your business plan, the market analysis and marketing strategy sections are where you convince readers that your business will be successful.

The market analysis section should provide a specific and detailed analysis of your target market, including what you have done to maximize your opportunity within it. Who are your current and potential customers, and why? Summarize any market research you have conducted to prove the viability of your business. How big is your potential market? Who are the major competitors?

If your business plan is intended for potential investors or lenders, this section will help convince them that you truly understand your market and are an expert in your industry. If your plan is primarily designed to educate key employees, it will provide the basic information they need to strategize and carry out your vision for growth.

Once you have conducted thorough market research, the next step is to brainstorm how you will market your product or service within your industry. This marketing strategy section of the business plan should provide details about how you will promote your products and services. How will you differentiate yourself from the competition within your target market? What is your business's value proposition (i.e., the unique value that your company offers the marketplace), and how will you communicate it to your stakeholders? Describe any marketing tactics, such as advertising and public relations, as well as sales models and sales compensation structures.

While the market analysis and marketing strategy sections may be the most time-consuming to put together, they will be well worth the effort. Conducting thorough market research can uncover previously unknown challenges and opportunities. Addressing these findings with a creative strategy can give your business a competitive edge. It can also help your business's leadership team understand the reasons for certain strategic decisions you make that they may not necessarily agree with.

Financials

Of particular importance to potential investors and lenders, the financials portion of the business plan is designed to help readers understand your current financial position and where you hope to be. If you are seeking money, this section should outline exactly how much you need and why. Include all current and projected (or "pro forma") financial statements, including:

- Cash-flow statement
- Balance sheet
- Income (or profit and loss) statement
- Break-even analysis

This section will likely be scrutinized the most, so be sure it is completed carefully. Some readers will require more information than others. What is most important is that the information you provide is accurate and well supported with documentation. The main purpose of this section is to educate readers about the use of resources--including any debt and equity financing you hope to get--proving to them that you and your leadership team can and will manage money effectively.

[1] Examples have been simplified for illustrative purposes. Actual results would differ.

Choosing a Business Entity

When launching a new venture, one of the first decisions you will make is determining which structure, or "entity," your business will assume. Depending on which entity you choose, the decision may affect your own and your business's tax situation, the level of protection your personal assets (including your home) receive, and the amount of control you have over the business.

Following is a brief primer to help guide you in your choice. You may want to consult a qualified attorney or financial professional before making your final decision.

Attributes of different entities

Formalities of existence

Some types of entities are simple and inexpensive to form and maintain, while others must meet specific requirements. If you want to keep the overall management of your business as simple as possible, you might choose an entity with few formalities.

Liability

Chances are you've heard the term "limited liability." An entity that offers limited liability means that an owner can lose nothing more than his or her investment in the business. Personal assets--such as a home and personal savings/investment accounts--are insulated and cannot be used to satisfy an owner's financial obligations. On the other hand, some entities offer little in terms of liability protection. When choosing an entity, consider carefully how much you are willing to risk.

Taxation

Some entities are considered "pass-through," which means profits pass to the owners for income tax purposes. By contrast, businesses that are not structured as pass-through entities are required to pay taxes at the corporate level.

Although it may be tempting at first to avoid a pass-through entity--thereby avoiding a personal income tax obligation on all of the company's profits--in reality it may be more beneficial to structure your business in this manner. The reason? As a separate taxpaying entity, the business will pay taxes on the corporate profits, and any dividends that are passed on to the owners will be subject to taxes again on the owners' individual income tax returns. This is known as "double taxation." Of course, the final decision depends on your unique needs, as well as those of the business and any partners you may have.

Example(s): *Assume that Shareholder A is the owner and sole shareholder for Acme Corporation, a pass-through entity, and is in the 35% individual income tax bracket. Acme Corporation has $100,000 in profits, which are passed along to Shareholder A. The total tax obligation is $35,000 ($100,000 x 0.35).*[1]

Example(s): *Now let's assume that Acme is not a pass-through organization and is in the 34% corporate tax bracket. With $100,000 in corporate profits, Acme would pay $34,000 in taxes ($100,000 x 0.34). If the remaining $66,000 is then passed to Shareholder A in the form of dividends, the amount would be taxed again at the 15% qualified dividend rate, resulting in an additional tax obligation of $9,900 ($66,000 x 0.15). The combined effective tax rate in this example is 43.9%, or $43,900, $8,900 higher than in the first example.*[1]

Centralized management

Some entities permit centralized management, while others do not. An entity has centralized management if a person or relatively small group of people (such as a board of directors) has responsibility for making key governance decisions. If you hope to manage the bulk of the major decision making within a small group of people, choose a structure with centralized management.

Flexibility in sharing profits and control

Some entities are more flexible than others in sharing profits with their owners (including the types of stock that can be issued). If you would like to maintain control over distribution of the profits, keep this point in mind when selecting an entity.

Continuity of life

Some entities can "live" forever, even when an owner dies, goes bankrupt, retires, or becomes incapacitated or disabled in some way. Others are required to dissolve upon these events.

Transferability of interests

Free transferability of interests exists when owners are permitted to sell their ownership

2 There are costs and expenses associated with the creation of these legal entities.

3 Certain publicly traded partnerships are taxed like C corporations rather than as partnerships.

interests to others without restriction. Some types of entities restrict an owner's ability to transfer interests.

Types of entities[2]

C corporation

This entity consists of one or more owners. The owners, who purchase stock (a "piece" of the business) from the corporation, are known as shareholders. A C corporation offers limited liability and centralized management. The shareholders are generally protected from creditors of the corporation and only risk the loss of their investments. The management in a C corporation is centralized in the board of directors, though the shareholders indirectly participate in management by electing directors and voting on certain corporate issues. By law, the shareholders may buy and sell their stocks essentially without restriction (free transferability), although contracts among the owners often restrict this ability.

Because C corporations are separate taxpaying entities, they are potentially subject to double taxation.

Sole proprietorship

A sole proprietorship is a one-owner, one-operator business. It is the easiest type of business to set up because there are no requirements for legal documentation. Generally, you simply start doing business. But it is also among the riskiest in terms of personal liability. This structure can put nearly all of your personal assets at risk.

Taxes are recorded on your individual income tax returns. And because you are the only owner in this type of entity, you manage all the decisions and the profits. Upon your death, disability, or incapacity, the business will cease to exist unless you decide to sell or transfer it. The sale or transfer can be as complex or simple as you would like to make it.

General partnership

A general partnership must consist of at least two owners (partners), although there is no limit. Forming a general partnership is usually simple and inexpensive, typically with fewer formalities than with a corporation (although a partnership agreement is recommended). General partnerships have a great deal of flexibility in determining how profits and management duties are distributed.

Taxes are passed through to the partners, avoiding the risks of double taxation. A general partnership does not offer limited liability, and partners can be held liable for each others' actions. Ownership interests can be freely assigned as long as the move is not prohibited in the agreement; however, they typically cannot be sold. Upon the death, disability, or retirement of a general partner, the partnership usually dissolves unless the remaining parties have agreed in writing to continue the business.

Limited partnership

A limited partnership combines limited liability and centralized management, and is typically governed by a partnership agreement. It is generally easy to set up and maintain, although there are some documentation requirements.

This entity has two types of partners: general and limited. There is no limit on the number of partners. Only limited partners receive liability protection; general partners are responsible for management and oversight, and for that reason, they remain personally liable. If a limited partner participates in management, the liability protection is lost.

A limited partnership offers some flexibility when allocating profits and control. Profits pass through the company and are recorded on the partners' individual income tax forms. In addition, ownership interests can usually be freely assigned unless prohibited by the agreement; however, interests cannot be sold. Withdrawal of a limited partner from the partnership generally would not result in dissolution of the business.[3]

S corporation

Like a limited partnership, an S corporation combines limited liability with pass-through taxation. And like a C corporation, an S corporation is owned by one or more shareholders who own stock. Unlike a C corporation, an S corporation is limited to a maximum of 100 shareholders. And although stock with different voting rights may be issued, different classes such as preferred and common are not allowed. Stock ownership is typically restricted to individuals, estates, and certain trusts. If stock is sold to an ineligible shareholder (such as a partnership), the corporation loses its "S" status and the (tax) benefits that go along with it.

Like a C corporation, an S corporation offers centralized management through a board of directors, and shareholders indirectly

participate in management by electing board members and voting on certain company issues. An S corporation would not cease to exist due to the death, disability, retirement, or other withdrawal of one of its owners.

Limited liability company (LLC)

An LLC can be taxed as either a corporation, a partnership, or a sole proprietorship. (However, you should be aware that some states do not recognize or permit LLCs with a single owner.) If taxed as a partnership (the typical choice), an LLC will offer limited liability and pass-through taxation without some of the disadvantages of a limited partnership or S corporation. For example, owners of an LLC (called members) can contribute to management without compromising their limited liability protection. Unlike an S corporation, an LLC is not restricted regarding the type or number of owners, or the types of stock that can be issued (although LLCs can also be structured as S corporations if they choose). LLCs also offer flexibility when it comes to the distribution of profits.

LLCs can have centralized management if they choose to do so. In many states, an LLC will be dissolved when a member leaves, unless otherwise noted in the member agreement. State laws should be reviewed before establishing an LLC.

Limited liability partnership (LLP)

An LLP is an entity form with similarities to both the general partnership and limited liability companies. This form offers more liability protection to the partners than a general partnership, but sometimes less than an LLC. The LLP is designed for professions that face malpractice suits, and may be adopted (if available) in those states that don't allow certain professionals to form LLCs. State laws should be reviewed before forming a limited liability partnership.

Professional corporation (PC)

The professional corporation is treated as a single entity and is unique primarily because its shareholders must generally be members of a licensed profession. Each state, by statute, defines the professions that may form a PC.

A PC raises its own money by selling stock to shareholders, and it usually handles profits by either distributing them to shareholders or reinvesting the profits in the business. It can assume the basic tax features of either a C corporation or an S corporation. Unlike a partnership, in which individual partners can be held liable for the negligence of other partners, shareholders in a PC can generally be held liable only for their own behavior. A PC offers centralized management and continuity of life.

PCs can be a bit more onerous and expensive to establish and maintain than other entities, and shareholders can typically transfer shares only to members of the same profession.

Selecting an Advisory Team for Your New Business

Running a business successfully requires a business owner to wear many different hats. Of course, you will need in-depth knowledge of your industry and product or service, but you will also likely face situations that require knowledge of finance, accounting, law, taxation, insurance, sales and marketing, human resources, and investment management, to name just a few. For this reason, you might want to consider cultivating a network of advisors to provide guidance as the business grows.

Your network could be a formal advisory board, which meets regularly to review your progress and provide input, a loose team of professionals coordinated by one financial professional, or an informal list of close contacts on whom you may call when certain needs arise.

Your team may be composed of people from both inside and outside your organization. The insiders may be part of your salaried management staff, while the number of outside advisors may be largely a function of their cost and your budget. While most advisors will work on a contract, retainer, or fee-for-service basis, you may be able to cultivate relationships with those who are willing to provide their advice for the price of a cup of coffee, the occasional lunch, or complimentary access to your business's service or product.

Should you ask friends or relatives to serve on your team?

If you already have relationships with people whose professional expertise could benefit your business, shouldn't you go to them first? While there's nothing wrong with asking for a bit of advice every so often, you might use caution when inviting friends or relatives to serve as official team or board members. When making decisions regarding your business, objectivity is key. You wouldn't want your decision making to be influenced by concerns about a personal relationship. If you do invite friends and relatives to join your team, be sure to have a frank conversation at the outset about everyone's expectations and how potential disagreements will be resolved.

Define your needs

To build your network, start by assessing your needs and breaking them down into their component parts. Do you need legal advice? How about a financial and tax expert? Will your business rely on a highly specialized sales force or an unusual marketing strategy? Do you need assistance finding qualified employees? Determining your most pressing needs will make it easier to find the appropriate contacts. Define each advisor's role first, then set out to identify your team members.

Find your key players

Credentials, experience, reputation, expertise, and cost are important factors when selecting an advisor. When considering a potential team member, particularly someone you don't know very well, be sure to perform due diligence on his or her background. Explore education and training as well as professional licenses. When considering a paid arrangement (such as with a tax advisor or attorney), request references and inquire about experience with other businesses whose situations are similar to yours.

Also ensure that any potential advisor has a demonstrated ability and willingness to work as part of a team, sharing ideas and guidance with other team members as needed. In fact, one way to develop an efficient team is to allow one trusted advisor to refer you to others he or she has worked with in the past. On the other hand, it's also important to keep in mind the old adage, "variety is the spice of life." Selecting a group of advisors based on one person's recommendation may result in a team with very homogenous opinions and approaches, rather than a dynamic and creative group offering many different perspectives. The bottom line is that you will need to be discerning as you select your advisors.

Another important trait among potential advisory team members is strong communication skills. Several of your advisors--notably attorneys and financial professionals--will be required to share complex information with you and the rest of your counsellors in a way that everyone understands. An ability to communicate esoteric concepts simply is key to help ensure that everyone is on the same page.

Formalize your arrangement

Once you have identified your team members and they have agreed to help you out, consider formalizing the arrangements through written agreements. Clearly spell out any financial arrangements and articulate the expectations you have discussed. Also be sure to cover such factors as confidentiality, meeting schedules, and the overall time frame for the advisory relationship (e.g., one year). You might also include language that discusses an option to renew the agreement.

t's generally advisable to formalize all financing agreements in writing--even with friends and family--spelling out agreed-upon interest rates, payment schedules (debt), and ownership arrangements (equity).

How Will You Finance Your New Business?

Before launching your new venture, there is one critical ingredient you will undoubtedly need: money. If you're lucky enough, you can bootstrap the earliest stages of your business with your own means. Then, at some point, if you're like many business owners, you'll need to explore outside sources of financing.

Also known as "capital," the money you use to finance your business may come from a variety of different sources.

Capitalizing your business

Generally, there are two ways to fund, or capitalize, your business. You can borrow money (debt) or, if you don't mind sharing ownership, you can find investors (equity). Debt must be repaid to your lenders. Equity, however, generally does not; it is simply exchanged for an ownership interest in your business.

Which method or combination of methods is right for your business depends on (among other things) how much money you need, your financial situation, the type of business you are launching, and how much control you are willing to share. Before soliciting funds from outside sources, you should consult with a legal advisor familiar with all relevant federal and state laws.

Debt

Put simply, debt refers to borrowed money. When you use a loan to borrow money, the full amount eventually has to be repaid, with interest. You can borrow funds on your own, or your business can borrow funds under its name if it is a separate entity.

If you borrow the funds under your own name, you become the debtor and are personally liable for repayment. You can either invest these funds directly in your business (equity)

ROBS

Another option for financing, which uses an IRA or 401(k) from a former employer, is called a rollover as business start-up, or ROBS. Using this method, you would create a C corporation, hire yourself as an employee, and establish a 401(k) plan for the business. Then you would roll over funds from an IRA or previous employer's 401(k) into the new plan, purchase stock in your new company with those funds, and use the money raised through the stock purchase to fund your start-up expenses. The IRS will take a particular interest in a business funded in this manner, so be sure you fully understand the rules. For example, be sure the valuation of your company's stock price is realistic and defensible. Because 401(k) plans are governed by complex regulations, you may want to consult a qualified retirement plan advisor before choosing this route.

or loan the money to the business. On the other hand, if your business borrows from a third-party lender, *your business* is the debtor responsible for repayment. However, even if your business is the borrower, a lender may require you to personally guarantee the loan, in which case you would be liable for its repayment.

A loan can be an installment loan or a line of credit, secured or unsecured, and short term or long term:

1. **Installment loan/credit line.** An installment loan is money provided in one lump sum that must be repaid in installments (e.g., monthly). A line of credit, on the other hand, permits the borrowing of funds as they are needed; the funds usually have to be repaid within the year.
2. **Short term/long term.** A loan is considered short-term if it must be paid within one year. Conversely, a loan is considered long term if its term is longer than one year.
3. **Secured/unsecured.** A loan is secured when the lender is given an alternative form of payment in the event of default (failure to pay). The asset that constitutes the alternative form of payment (the home, for example) is called "collateral." There are many forms of collateral, including but not limited to real estate, inventory, equipment, and accounts receivable (what people owe you). Unfortunately, if you have little or no collateral, you may encounter much difficulty obtaining a loan.

The lender will consider several factors when evaluating a loan request:

1. Your credit history
2. The risk of failure of your type of business (new businesses are considered riskier than established businesses)
3. Your personal and business income, both current and projected
4. Your business/managerial experience
5. Your equity in the business (the amount you contributed to the business)

One of the advantages of debt over equity is that you do not have to share ownership and control of your business. When you repay the debt, your obligation will be fulfilled.

One of the disadvantages of loans is that they can be difficult to obtain, and once a loan is acquired you are obligated to make the monthly payments. In addition, the total amount you repay will likely be much larger than what you originally borrowed because of the interest charges. If you ever fail to repay, you could be assessed penalty fees, given a bad credit rating, or have the loan "called" (requiring you to pay it immediately in its entirety), which may cause you to lose the business.

Equity

Equity represents all the money invested in your business (i.e., not loans). Such funds are exchanged for an ownership interest in the business. Although you are not *required* to pay the money back, most investments are made with the expectation of receiving ownership rights in the business, including a share of future profits (or losses), and sometimes even the ability to weigh in on management decisions. Essentially, you are selling a piece of your business.

Examples of equity include funds contributed by you, your family and friends, angel investors, venture capitalists, and any money raised through the new equity crowdfunding platforms.

When soliciting substantial amounts, you should generally look for investors who have experience with, or at least understand, your type of business. In addition, you should seek out investors with whom you are compatible. There's nothing worse than sharing ownership of your business with someone you dislike!

An equity investor typically looks for a high investment return. Naturally, such an investor is not going to risk his or her money unless you can prove that the business has the potential to be successful and profitable.

An obvious advantage of equity over debt is that you do not have to repay the funds. Because equity investors are eager to make a profit, they might be more willing to take risks than debt investors, who worry about getting their money back.

On the other hand, an equity investor will usually expect you to surrender some control over the use of his or her money. This means you may have to consider the opinions of others on how the business should be run, regardless of how disagreeable they may be.

Finally, equity financing can be relatively complicated. In most cases, paperwork needs to be prepared and filed, and various regulations adhered to (e.g., laws regulating the sale of stock and other securities).

Sources of financing

Once you begin to explore the opportunities, you will discover many possible sources of financing.

Yourself

If you are unwilling to risk your own assets, other potential lenders and investors will likely be reluctant to provide funding. For this reason, you could quickly discover that the most important sources of your business financing, at least in the earliest stages, are your own resources. However, be sure to consider self-funding cautiously and only after a period of honest reflection, family discussion, and careful preparation.

For example, might it be best to moonlight in your new venture while maintaining your current job, so that you continue to receive a steady income and health benefits while your business gets off the ground? And although the typical recommendation for emergency savings is to hold three to six months of income in a liquid savings vehicle, it may be advisable for you to increase your emergency savings to the equivalent of one year or more of income before quitting your day job. The reason? While your new venture is in a start-up phase, you may not be able to draw a salary. If that's the case, how will you afford to live? Also, don't view your savings as a source of cash for the business. It is for you and your family to cover expenses while your business gets off the ground.

With those points in mind, here are some options you might consider for self-funding:

- **Savings:** Any amount you invest directly in the business is considered your equity. If you contribute $10,000 toward your start-up, for example, you will have a $10,000 ownership stake in the business.
- **Employer-sponsored retirement plan:** You or your spouse might be able to borrow some money from your 401(k) or other retirement plan. Keep in mind, however, that the maximum amount you can borrow is 50% of your vested balance or $50,000, whichever is less. And if you (or your spouse) leave the company prior to paying back the loan, the outstanding amount will need to be repaid within 60 days or it will be treated as a distribution, subject to all applicable income taxes and penalties.
- **Life insurance:** If you have amassed a cash value in a life insurance policy, you may be able to borrow against it. Check with your insurance provider.[1]
- **Credit card:** Yes, it is true that some entrepreneurs use credit cards to fund their start-ups, but it may not be the wisest choice. Though credit cards are a source of quick cash, you will likely pay an inordinate amount of interest on the borrowed funds--and end up with a serious amount of debt if the business fails.
- **Home equity:** You can also borrow against the equity in your home by securing either a home equity loan or line of credit. However, keep in mind that you risk losing your home if the loan goes into default.

Friends and family

You can look to friends and family members for both loans and equity investments. The advantage of borrowing from this group is that you may be able to negotiate very favorable terms. And the advantage of sharing ownership with friends and family is that you may be able to do so without giving up too much control. After all, who has more faith in your abilities than those who know you best?

A word of caution: It's probably a good idea to formalize in writing any equity and lending relationships with friends and family members, specifying amounts of control you will share (equity) and interest rates and payment schedules (loans) that will apply. And remember to respect the financial arrangement as outlined in the formal documentation, so as not to strain the overall relationships with your nearest and dearest.

Banks

Although a small-business loan from a bank is an option, banks are typically reluctant to lend to unestablished businesses without collateral. If and when a bank lends to a new business, it often requires a large equity stake from the owners first.

Small Business Administration

The SBA is a federal program that provides counseling, education, and financial assistance to small businesses and start-ups. Though the SBA offers some direct loans in certain circumstances, it primarily acts as a loan guarantor for qualified business owners. The primary lender is a traditional financial institution (e.g., community bank) that participates in the SBA programs. For more information, contact your local SBA office, call the Answer Desk at 800-827-5722, or visit the SBA's website at sba.gov.

[1] Access to cash values through borrowing or partial surrenders can reduce the policy's cash value and death benefit, increase the chance that the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured. Additional out-of-pocket payments may be needed if actual dividends or investment returns decrease, if you withdraw policy values, if you take out a loan, or if current charges increase. There may be surrender charges at the time of surrender or withdrawal and are taxable if you withdraw more than your basis in the policy.

[2] Before making any investment commitment, an investor must provide a representation that he or she has reviewed the intermediary's educational materials; understands that the investment is illiquid, that there is no guarantee of any return, and that the entire investment may be lost; is in a financial position to bear the loss of the investment; and has completed a questionnaire demonstrating an understanding of the risks of any potential investment and other statutory requirements.

Small Business Investment Companies

SBICs are privately owned organizations licensed by the SBA. Like the SBA, SBICs provide financial assistance, as well as counseling and guidance. Specialized SBICs offer assistance to entrepreneurs considered socially or economically disadvantaged. For more information, contact your local SBA office or the Small Business Investor Alliance at 202-628-5055, or visit the SBIA website at sbia.org.

Economic Development Administration

This federal agency, an extension of the U.S. Department of Commerce, provides financial assistance to businesses located in economically deprived areas of the country. For more information, call the EDA at 202-482-2900 or visit the website at eda.gov.

Angel investors

"Angels" are usually individuals with lots of money who invest in start-ups. Because they typically engage in such investments regularly, they may be a good source of business expertise. The challenge can be with the amount of control and ownership they will require in exchange for their investments.

Venture capital

VC firms are typically interested in businesses in which they see identifiable and measurable profit growth potential. Typically, that means a business with an already proven business model--i.e., not typically a brand-new business. Also consider that VC investors may demand a good amount of control, but with this control could come a valuable level of advice and guidance as well.

Crowdfunding[2]

What started more than a decade ago as a way for art and music lovers to fund their favorite artists' projects over the Internet has evolved into a sophisticated way for small-business owners to raise capital. Small businesses can now use established "funding portals" to raise a limited amount of money each year from small investors. As a practice regulated by the Securities and Exchange Commission, crowdfunding is subject to a series of rules and procedures that businesses and funding portals must follow. For more information, visit sec.gov.

Incubators and accelerators

These organizations provide valuable resources and mentorship to new businesses. The difference is that one is intended to "incubate" a new business idea, while the other is intended to "accelerate" the growth of an existing business. The programs are typically highly competitive, and business owners must apply for them. If accepted, entrepreneurs may need to relocate and share space with others in the program.

For more information on incubators and accelerators, visit the International Business Innovation Association's website at inbia.org.

Keeping good records and having appropriate insurance coverage are important keys to success for any business owner.

Other Tips to Help You Succeed

Creating a business plan, choosing an entity, and cultivating your financing are three very important steps in launching your new business. But they are not the only steps. Here are several more relatively mundane--yet no less important--tips to help you succeed.

Keep careful track of financial records

Keeping good business records not only will help you stay in business but may help you increase profits. Your business records let you analyze where your business is and where it's going. They point out potential trouble spots and serve as a guide to where you want your business to be.

You may need to purchase software to help track your records. Some commercial record-keeping systems are generic in format and applicable to many types of businesses. Others are designed for specific types of business operations (e.g., retail sales and manufacturing). Most generally will offer the ability to summarize your business activity with appropriate periodic financial reports.

You can decide to keep your own books and records or hire someone to do it for you. Your decision depends in part on how much time and ability you have for the task. You can hire a company that specializes in payroll services to handle the paperwork and withholdings for your employees. Most small-business advisors suggest that you have an accountant prepare your tax returns and year-end statements. In many cases, an accountant can also offer advice on various aspects of financial management, such as cash-flow analysis, borrowing for the business, tax considerations, and suggestions for which

software to buy for record keeping. Whichever way you go, you should stay involved in the record-keeping process.

What your records should help you do

- Determine cash-flow requirements. Bank statements measure cash on hand, while accounts receivable predict future income. Together, these records can help you determine your need for short-term borrowing.
- Payroll records help provide income tax information to employees, as well as help you assess your product/service pricing.
- Inventory records help you avoid lost profits due to over- or under-supply of goods.
- Expense records help you predict your cash flow, as well as determine whether the income generated from a particular service, product, or activity fully supports the associated expenses.
- Income statements help you assess the profitability of the company as a whole, as well as pinpoint areas that may be losing money.
- Balance sheets capture a snapshot of your company's financial picture at a specific moment in time, helping you compare your company's financial situation to competitors and gauge how your organization performed against projections. It can also help you calculate important ratios--such as debt-to-equity ratio--that can help you measure the overall financial health of your business.

One of the most important reasons to keep good business records is to help yourself (or your accountant) come tax time. For this reason, you may want to choose or establish a record-keeping system that tracks your income, expenses, payroll, and other records in a manner consistent with the needs of your tax returns. For more information, see IRS Publication 334, Tax Guide for Small Businesses.

Finally, how you manage your records will be vital to your ongoing efficiency. You should maintain a good system to ensure that both your physical (paper) and digital (computer-based) records are retained as long as necessary and disposed of properly. Ensure that your digital systems are adequately protected from data theft (e.g., ensure you have a firewall) and be sure to have proper redundancy (backups). A good rule to follow is the 3-2-1 rule, which states that you should maintain at least three copies of your data, in at least two different formats, with at least one copy stored offsite (such as a highly secure cloud storage solution).

Cover your assets

"Cover your assets" seems a little more attention grabbing than "make sure you have proper insurance coverage," but it means basically the same thing. Having the appropriate types and amount of insurance coverage can help protect your business from a variety of risks.

While your specific insurance needs will depend, in part, on the type of business you own, you should consider at least three specific types of insurance:

1. **Property insurance.** This coverage helps protect your property, up to policy limits, against various losses that can result from natural and man-made causes. Check the policy to determine what assets and events it covers, and purchase riders for any additional coverage you think is necessary. Even if you lease space (rather than own a building), you'll want to protect the business's possessions. If you run your business out of your home, you should consider purchasing separate business property insurance because your homeowners policy does not cover the use of your home for business purposes.
2. **Liability coverage.** This type of insurance provides coverage to help cover legal costs and payouts if the products or services you provide cause injury or harm to your customers or their property. Liability insurance will cover these types of incidents, as well as associated attorney fees and costs. Errors and omissions insurance is one type of liability coverage.
3. **Workers' compensation insurance.** If you have employees, your state may require you to purchase workers' compensation insurance. This will cover medical expenses and at least a portion of lost wages in the event that employees are injured or become ill as a result of their employment. State law determines the maximum number of workers who may be excluded from mandatory coverage and the types of employees (e.g., independent contractors) who may be excluded.

Other types of insurance you may need for yourself or your employees include health, dental, and vision coverage; disability insurance; life insurance; and long-term care coverage.

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