The Issue

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Top Ten Mistakes Startups Make

and how to avoid them

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While this Newsletter typically tries to address topical issues in the world of Finance, the Law, and Accounting, every once in a while, it's good to revisit basic blocking-and-tackling issues, the *fundamentals*, so to speak. Certain lessons are never learned, oft repeated, or just plain ignored. This edition of The Issue will remind us of the mistakes many startups typically make. Avoiding such mistakes in the company's infancy will help set the company on the right path.

And for those of our clients who think they recognize others in the passages below (but not themselves), not so fast! These pearls of wisdom have been developed from many decades of shared experience.

No. 1 Financial Mistake: Spending without a Plan

A sudden infusion of cash often causes the floodgates to open. Every single employee gets his or her wish list (new laptops, big monitors, latest technology, updated software, new furniture, accessories, etc.) The equipment is bought without consideration for collective purchase discounts, or conversely, without regard to staging, as though all of the revenue would come in at once, instead of over a gradual period of time.

A colleague of mine uses the phrase, run your company with a "checkbook" mentality. The CEO of a startup should know at any moment in time the amount of cash in the bank, what is going to come in the next few weeks, and what is going out.

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In almost every circumstance, it helps to build a 13 week forward-looking cash forecast, which is updated weekly. Such a forecast can identify shortfalls in enough time to deal with them, as well as excesses which can be invested until needed. CFOs2Go professionals are experts at structuring these plans at the outset in a way that is simple and straightforward to maintain.

Call it a Plan, call it a budget, call it a pro forma, or call it a forecast; every company needs one. Why? Because, first and foremost, the process of putting a Plan together causes the company’s principals to think both tactically and strategically. The “Plan” should not just be “buckets of dollars”, but rather it should be based on accountable units (i.e. a payroll plan for employees, titles, salaries, taxes, benefits, number of computers to be purchased and their approximate unit costs, rent per location, etc.) and a specific timeframe, usually expressed in months. A lot of companies *think* they have plans, but when it comes time to report, variances cannot be explained in any meaningful way except to say, “we didn’t budget properly.” Finally the plan should assign accountability to specific individuals who are responsible to ensure that spending occurs within the confines of the plan.

The Plan should be tied to milestone achievements. Executives should consider contingency plans if milestones are not achieved, or operating results fall below forecast or are otherwise delayed. If the plan needs to be changed or updated, it should be done with the complete knowledge of the CEO and his executive team.

No. 1 Legal Mistake: Failure to “legally” document your Company’s status

When just a couple of entrepreneurs are brainstorming an idea in their garage (think Jobs and Wozniak; Gates, Allen and Ballmer) it’s a little premature to think about organization. However, as soon as you are ready to employ people, enter into contracts, or decide actual “ownership” of the company, the founders need to formalize the organization and the relationships among themselves.

Choice of legal entity is important (corporation, limited liability company, partnership, etc.), and depends on many factors, such as size of company and expected duration, breadth of ownership, growth potential, interests of the investors, succession plan, etc. A well-qualified attorney, such as those at Royse Law, can help founders make these decisions thoughtfully. The most important reason for forming a separate legal entity is to shield the owners / investors from exposure to personal liability. Doing this at the outset protects the rights of all.

Document the ownership percentages and relationships of the founders at the outset. In this regard, the founders need to be totally transparent with one another. Work out the kinks on the front end, and address fundamental issues which are likely to cause friction in the future .– Keep in mind the Facebook founder dispute, and don’t get into a situation where one founder can later claim that he or she was maneuvered out of his/her ownership interest due to ignorance or poor communication.

Also, carefully document employment relationships, assign responsibilities and objectives, and determine compensation. Include deferred compensation in the discussion, including options to acquire additional ownership, vesting schedules, and benefits (both now and in the future.)

Define the circumstances under which owners can exit the relationship, including conditions for withdrawal, buy-back, or forfeiture, whether voluntary or involuntary. These circumstances will arise; hence they are best handled upfront, so when the moment arises, there is a minimum of confusion or animosity.

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Financial Mistake No. 2: Treating the company as your own piggybank

This topic is self-evident to seasoned and serial entrepreneurs, but with the number of recent college graduates forming companies right out of school, either by desire, or lack of employment opportunities, the temptation to comingle business and personal activities when one is financially challenged is great. In a word, "Don't".

Open separate bank accounts for personal and business expenses. Use separate credit cards. Clearly document the business relationship of business-related entertainment expenses. Log or separate use of what the IRS terms, "listed property," those assets such as cars, computers and cellphones which have both personal and business uses. Document actions of the Board and Executive Team with minutes. In short, operate your business, as a business.

A common litigation strategy is to "pierce the corporate veil", i.e., going after the personal assets of the owners by showing that the business was not operated as a business.

Particularly in situations where the capital used to start or operate the business is coming from investors who do not hold a majority voting right, have a fiduciary attitude towards the investor's money. You'll find little comfort in the notion that "we were in the majority and therefore could do anything we wanted" when an action is brought by the minority investors for mismanagement of their funds.

Legal Mistake No. 2: Ignoring your obligations under IP and Trade Secret Laws

This mistake is particularly true in the high technology environment that many of us live in. On the defensive side, know and understand your obligations under trade secret and intellectual property laws. Have a plan in place for rolling out your new company that does NOT violate these laws. Trade secrets are broadly defined to include "information" that is not generally known to the public, has economic value and is treated as confidential by the holder of the secrets. This includes both technical-type information (i.e., software code, manufacturing methods) as well as non-technical information such as customer and supplier lists, marketing plans and financing plans. When starting up a new venture, resist the urge to start a new company that is engaged in business activity that is identical or very similar to that of a founder's former employer or partner. Courts do not hesitate to issue injunctions to prohibit use of a company's claimed trade secrets when there is strong evidence to establish trade secret theft from a third party. Carelessly ignoring trade secret and other intellectual property laws will be the death knell of your new business venture; implement a strategy for your company which avoids potential trade secret or other litigation.

On the offensive side, avail yourself of the protections the law affords under trademark and patent law. If you suspect that someone is using your confidential trade secrets, consider taking an aggressive approach and informing them that you intend to protect your intellectual property. If you ignore a breach, a court could find that you voluntarily relinquished your ownership of your trade secrets or other intellectual property. There is nothing worse to the enterprise value of your company than spending hundreds of thousands, or even millions of dollars developing a technology, only to have it "stolen" by an unscrupulous, aggressive or better-financed competitor. In short, do not ignore violations – fight to protect your property.

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Financial Mistake No. 3: Failure to develop a meaningful accounting system from the outset

Accounting systems, even sophisticated ones, are dirt cheap these days. Whether one elects to buy an inexpensive desktop system or “rent” a more sophisticated system “in the cloud”, there is no longer any excuse for keeping the company’s books-and-records in a checkbook or on spreadsheets.

Second, don’t treat that system as just a repository for receipts and disbursements until the tax guy sorts it out each year, three-to-fifteen months after the fact! Setup the system from the beginning that is organized and provides timely and meaningful financial information daily at the press of a button.

A good financial reporting system starts with an organized Chart of Accounts. Do NOT use the “canned” COA’s that come with most accounting systems. Often those account structures are not organized to provide meaningful information to the user. For instance, what good is an alphabetic sorting of accounts that does not group “Salaries”, “Payroll Taxes”, and “Employee Benefits” together to determine the overall cost of the employment base. Similarly, “Rent”, “Property Taxes”, “Janitorial” and “Utilities” should be grouped together to report the total cost of facilities. An hour or two by a professional, such as we at CFOs2Go, should not be eschewed on the basis that it is not “Sales” or “R&D” related. It can pay enormous dividends down the road.

Develop a system, whether by purchase orders or otherwise, where expenses are pre-authorized before they are incurred. There is very little that can be done once an expense has been incurred, but a lot that can be done in advance.

Insist that vendor invoices, employee expense reimbursements, and contractor payments be processed promptly. The system is only as good as the data within it, and there is nothing worse than to think you are operating within budget, only to be surprised by expenses that are several months old that are only now coming to the forefront.

Legal Mistake No. 3: Do not ignore employment laws or regulations

Comply with employment laws from the outset. Don’t pretend that your company is immune to employment laws because you don’t have money or you are a startup. Ensure that offers of employment and employment agreements meet legal standards and include “employment-at-will” language, and make sure all of your employees are legally qualified for employment in the U.S.

Many startups fall into the trap of thinking that they can treat their workers as independent contractors, rather than employees. This mistake can cost you your business. Individuals who work full or close to full time for your company, do not work for anyone else and devote all of their professional attention to your company are going to be treated as employees by taxing authorities and other governmental authorities. You should have an attorney vet your decision to treat a worker as an independent contractor rather than an employee. Employees must be paid at least the governing minimum wage and must be paid on a timely basis pursuant to the Labor Code. Employee lawsuits for wage and hour, minimum wage and related violations are extremely expensive to defend, and can destroy the confidence of your employer-employee relationships. Damages in such lawsuits will include not only back wages for your employees, but also attorney’s fees for employees. Moreover, the existence of a judgment could, down the line, impact your company’s ability to obtain funding.

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Another typical mistake is to treat all employees as exempt from overtime laws. State regulations impose strict requirements for exempt classification of employees. Resist the temptation to allow your employees to determine their own classification status; oftentimes the employees who insist that they be treated as “exempt” for status and prestige reasons are the same ones that bring a lawsuit for overtime wages. In addition to paying non-exempt employees overtime wages when required, you must provide these employees with meal and rest breaks as required under the Labor Code. You should require that your non-exempt employees take these breaks, and only allow them to decline to take breaks when you have written confirmation from them that their decision was voluntary. Invest in a time clock or punch-in system; this is the best way to prove to a Court or the Labor Commission that your non-exempt employees were paid for all overtime hours worked and they took required breaks. Don’t let your employees bully you into adopting lax record keeping requirements; written records will allow you to win the “he said, she said” debate in a courtroom or before the Labor Commission where the benefit of the doubt is oftentimes given to employees.

In short, pay attention to the small stuff. Employee problems are often the largest problems a company will face in its early years.

Financial Mistake No. 4: Failure to pay taxes

While this might seem obvious, the world of taxation is vast and includes federal and state income taxes, employment or payroll taxes, real and personal property taxes, sales taxes, use taxes, local taxes, foreign taxes, and specialty taxes. With government agencies continually strapped for cash, they are continuing to search for ways to tax anything and everything to bring in additional revenue. Did you know that, for instance, the State of California (with a June 30th fiscal year end) expects *calendar year* taxpayers to pay 70% of their entire year’s estimated taxes by June 15th?

A common area of oversight is in the area of payroll taxes. Some payroll services calculate, but leave it to the company to pay directly, their federal, state and local employment taxes. Particularly the new unsuspecting entrepreneur may be left with the impression that they have either paid those taxes, will receive a bill for those taxes, or through ignorance or otherwise, believe those taxes are due at some indeterminate time in the future. Employers remit to the government two types of payroll taxes: (1) taxes withheld from their employees’ paychecks, and (2) taxes assessed on the employer itself. Unremitted taxes in the first category are considered “trust fund” liabilities and carry potential criminal liability to the owners of the enterprise, regardless of whether the enterprise is incorporated or not. Best to use one of the many payroll services that collects and remits ***all*** taxes with each payroll.

Through your financial or legal professional, obtain a schedule and timing of all taxes likely to be due from your business, and make sure that your taxes are paid on time. The level of penalties that can be assessed, including potential civil and criminal liability not shielded by a corporate structure, and the ability of the agency to file liens and close down the business, does not warrant ignorance in this area.

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Legal Mistake No. 4: Document your legal relationships

Handshakes are simply not enough. The devil is often in the details in most legal relationships. Avoidable misunderstandings grow where issues that could have been negotiated in advance are ignored for the sake of expediency. In the event of a legal dispute, the Courts are going to look to you to prove your claims (or defenses) by written documentation. Amicable relationships in business, including those between best friends or old colleagues, frequently fall apart for personal and other reasons having nothing to do with the company. Assuming that you will never "need" to rely on written documentation is fraught with unnecessary risk.

Keep all fully-executed contracts in a single and secure repository onsite, either in locked file cabinets for paper documents or on a secure server for electronic documents. Access should be limited to only those with a need-to-know. Remember that all filing systems should be organized as "retrieval" systems, such that when a file is needed it can easily be located in an organized fashion.

Financial Mistake No. 5: Keep some of your powder dry

This is a corollary to Financial Mistake No. 1, but of sufficient importance to deserve its own topic. Often there is pressure by the investment group, particularly if they are venture capitalists, to "get the money working" as soon as possible. This should NOT be interpreted to mean initiating a Plan without any reserves for unforeseen contingencies.

In particular, don't confuse Friends-and-Family or Angel Money with Venture Capital. Venture Capitalists invest for a living, have years of experience, have expectations for timing and amount of their financial returns, are likely more industry-focused and have resources to expand a business or weather financial storms. VC's often engender the belief that investing by them is like taking a cross-country journey by car, in which there will be a gas station in Denver and Chicago on your way from the West Coast to the East Coast.

In contrast, and while not true in all cases, Angel investors tend to be less sophisticated. Their desire is to put a limited amount of capital into one or more of entities, where they have a personal interest. In most cases, the first check you receive from an Angel investor will be his or her last. So it is very important to treat those funds accordingly.

A financial professional can also help you "stretch" you investment dollar, by leasing certain equipment, providing a low-cost line of credit to finance standby letters of credit for things like security deposits on real estate, and asset-based lending for receivables, inventory, and fixed asset purchases.

Legal and Financial Mistake No. 5: Corporate governance

Don't ignore corporate governance issues just because you believe they are just the province of the "big boys". Corporate governance applies to business entities of all sizes, and begins with the Chief Executive Officer setting the "tone at the top." A system of internal controls over financial transactions, an independent and engaged Board of Directors, budget accountability, setting up a whistle blower policy, and adopting a code of ethics is something companies of all sizes can afford.

Do not ignore your obligation to conduct board meetings and document board decisions with minutes and other required legal documents. Avoid the temptation to make decisions on an informal basis, and thereby neglect to satisfy statutory requirements.

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Summary

Often the mistakes pointed out in this Newsletter are the result of management focusing all their early resources on “sales” or “research and development” at the expense of administrative expenditures. However, the financial advice contained in this Newsletter need not be expensive. A few hours with a financial or legal expert can help your new and fledgling business from avoiding the potholes that ensnare many an unwary entrepreneur. If this Newsletter has prompted any questions in your own mind, don’t hesitate to call either Chris at CFOs2Go (408) 309-1343 or Lisa at Royse Law (650) 813-9700, ext. 221.

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