Long Island Business News

Startups & Downs: 9 mistakes that new businesses make

By: Bernadette Starzee June 26, 2018

Starting a business is risky business. One in five new companies do not survive the first year, and only about half are still around after five years. Accountants and attorneys who work with small businesses talked about some of the most common mistakes that new companies make. Here is a look at nine pitfalls to avoid.

1. Being undercapitalized

"The number one downfall of small businesses – with as many asterisks as you can think of – is undercapitalization," said Tony Perrone, a partner at DSJCPA, a public accounting firm in Westbury. "People don't anticipate the capital that will be required."

In addition to the money needed to start a business, founders need to set aside at least three months of operating expenses, Perrone said.

"Even if you start strong, you have to allow time to collect payments from customers," he said. "You have to give them payment terms."

When they start out, "many companies underestimate how much they're going to need to get their mission accomplished," said Al Materazo, partner in charge of small business for Margolin Winer & Evens in Garden City. "If you run short, it can be hard to go back to the well a second time. If you can't find capitalization, you can lose your business investment."

2. Not having a business plan

A lot of the mistakes small businesses make stem from not having a business plan, Materazo said.

If a business plan is well-written and well-thought-out, he said, it will define who the executives are and what their roles are, as well as identifying the competition and target customers, and providing a plan for operations and marketing and a complete set of financials with projections that lay out what the capital sources will be.

"In formulating a business plan, you need to have the target market identified, and figure out whether you are in the right location to reach your target, and what advertising is necessary to get your name out there so the target knows you are there," Perrone said. Further, he said, "having a solid plan that identifies costs will help you price the product properly so you can make a profit."

3. Not getting the right help

Robert Spielman: Startups must consider various risks they face and get the necessary insurance. (Photo courtesy of Marcum)

Another thing that startups often do wrong is trying to do everything alone, Materazo said. In many cases, "They don't want to spend the money," he said.

One big area is legal, he said.

"I advise that startups look for an attorney that is experienced in the area of business that they need and not just say, 'Hey, my cousin's an attorney; he'll be my attorney,'" Materazo said. "If you're a technology company, look for an intellectual property attorney. If you're getting involved with a franchise, you need a franchise attorney. If there's a real estate component – if you need to buy a building – seek out a real estate attorney."

Perrone said a surprising number of startups run into problems because they lack knowledge of the laws and permitting requirements of the local municipalities.

"This can cause excruciating delays in opening a business, which leads to a lack of cash flow, and then undercapitalization comes into play," Perrone said. "You can't float it for that long a period of time. Consulting with an attorney from the onset is essential."

Startups should also find a trusted accountant to guide them along their path.

"Many times startups underestimate the complexity of what they're getting into," Materazo said. "They may go with a bookkeeper when they need an accounting firm with multiple areas of expertise to help them as they grow."

Startups must be mindful of the "taxes that create personal liability: sales tax and payroll tax," said Robert Spielman, a partner in the Melville office of accounting firm Marcum. "Make sure you hire professionals and get those right."

4. Letting infrastructure lag behind sales growth

Some startups grow very rapidly out of the gate, but they get into trouble when their infrastructure doesn't keep pace with the sales growth.

"They don't hire the internal accounting or customer service people that they need, the proper forms aren't filed and other regulatory matters are not taken care of because there's nobody there to get it done," Materazo said. "When infrastructure does not keep pace with top-line sales, there's no one to babysit those items. Certain things can be outsourced, but you need to have the right people on the inside."

Further, a lot of times founders don't hire the right executives, Materazo added.

"They think since they're the founder, they should be the CEO, rather than maybe the top salesperson if that's their strength, or maybe the top operations person if they understand how to provide the service or build the product," he said. "They may not be the greatest CEO or manager. It's important to set up infrastructure properly and have the right people in the right roles."

5. Taking on fixed overhead prematurely

While it's risky to let supportive infrastructure lag behind sales, the opposite scenario can also land startups in trouble.

"Some entrepreneurs take on fixed overhead before the revenue is there to support it," said Lou Pizzileo, a partner at Grassi & Co. CPAs, which is based in Jericho. "They may take on payroll they don't need right away, or they may sign a lease for more office space than they need. There are so many options for office space now – you can take on a little space at a time. You need to feed the business before taking on payroll or a larger space. It's a tightrope walk."

Entrepreneurs tend to be positive, "which is good," Pizzileo said. "But it's important to forecast cash flow and pay attention to the fixed monthly burn versus the revenue that's coming in."

6. Not having the proper partnership agreements in place

"The top issue that I come across when there are multiple founders or proprietors is that they don't have a clear understanding of how the relationship between them is going to work," said Richa Naujoks, a partner in the Jericho office of national law firm Nixon Peabody.

Not having a proper partnership agreement in place is a common pitfall for startups.

"I've seen things go south there," Pizzileo said. "When working with a partner, don't try to do it yourself on Legal Zoom. Get a professional on board and get a partnership agreement in place from the get-go – not three years or seven years into the business."

The agreement, according to Naujoks, should include a policy regarding the vesting of shares when a founder leaves.

"You want to avoid founder A, who owns 50 percent, getting an offer and leaving the startup and leaving founder B with only 50 percent," she said. "If you have some sort of vesting agreement, when one leaves, the other can get back the leaver's interest and start afresh."

7. Failing to protect intellectual property

Businesses need to take early precautions to protect their intellectual property. For many types of businesses, it's important to have a confidentiality and intellectual property assignment agreement in place, said Naujoks. It should be signed by founders, employees, contractors and other applicable parties.

For consumer-facing businesses in particular, it's important to apply for a trademark right off the bat.

"I've seen with more frequency than I would like that companies spend time and resources building a brand and then they go to trademark it, and they find that someone else has been building a business under the same name," Naujoks said. "Protect your name before you go too far down the road building your brand value around that name."

8. Not having the necessary insurance

There are different types of insurance businesses need to consider, such as liability, property and casualty and disability.

"If you have a business where the leader is very important, and that leader gets disabled and there's nobody to follow in his footsteps and no disability insurance, that's the end of the business," Spielman said.

Not every business is going to take out every kind of insurance.

"You need to look at all the different risks, and make sure you are satisfied with covering them or letting them go without coverage," Spielman said. "Both are business decisions."

9. Not having an exit plan

"When you start a business, you need to understand what you're going to do with this business down the road," Materazo said. "If you're planning to bring in private equity like venture capitalists, or you're planning to grow it yourself and look to sell it in seven to 10 years, or you're looking to hand it down to the next generation, you're going to go down different paths. Who you hire, when you hire them and how you operate the business will depend on what your ultimate exit plan is going to be."

The ultimate plans for the business may have an impact on the choice of entity. For instance, "if you're looking to develop the business and sell it within five or six years, you may be better off being a C corporation as opposed to a pass-through entity," Spielman said. "You can get the advantage of qualified small business stock under IRS section 1202," for which individual owners do not pay taxes on the first $10 million (per person) of gain upon disposition.

No matter what the entity type, decisions made with regard to who the owner is can have estate planning implications down the road.

"When you're first setting up a business, it's usually at its lowest value at that point," Spielman said. "Setting up ownership in trusts for children or a spouse may result in significant tax savings for estate planning purposes."