

Topical tips

Starting your own business

So you have had enough of working for others. You want to be your own boss and go it alone. Your dream can become a reality, but to achieve your goal there are many crucial commercial, financial and taxation issues to consider.

In this publication, we hope to give you a step by step guide to the key factors when starting your own business. This is an overview however, and because each business opportunity is unique, we do recommend that you seek professional advice before you start.

Step One: You and your plans

Over 1,200 new businesses start up in the UK every day, but, only a few succeed. 33% fail in the first year, 42% fail in the next two years and only 25% go on to make profits. Such a high failure rate occurs because either the owner was not suited to self-employment, the business was not commercially viable and/or insufficient attention was paid to the necessary financial planning at the outset.

If you are to achieve success, you will need:

- Confidence in yourself and your abilities
- A viable, commercial idea
- An adequate understanding of your market
- The right business format primarily (sole trader, partnership or limited company)
- Thorough planning in all its aspects
- Adequate financial backing
- Reasonable level of commercial & legal awareness.

Only you can judge the level of commitment that you are prepared to make, so be honest with yourself. Are you:

- Able to take the rough with the smooth?
- Determined and persistent?
- Prepared to work very long hours, even at weekends and for little immediate benefit?
- A self-starter? (you won't get very far if you have to be told what to do)

- Able to see yourself as your customers do and can you provide them with what they really want?
- Self-disciplined? (there won't be anyone there to make you go to work every day)
- Going to be reliable and responsible in all aspects of your business?
- Able to develop the necessary management skills and make careful decisions under pressure?

You should also consider the position of your family and dependents:

- Do you have their full support?
- Can you cope financially during those first months when you may not earn as much as you need?

Discuss your proposals with them and others to get their honest views.

Step Two: Research

You do need to consider your long-term aim for the business. If it becomes reasonably successful, will you want to sell it or keep it to provide a secure income and an interesting way of life? If you are truly positive about your plans, give some serious thought to their commercial viability.

Research is essential in this process and involves gathering together supporting evidence to convince you, your potential backers and customers of the viability of your business. It is also a basic ingredient of your business plan especially where you need to obtain external financial backing.

The cost of obtaining research can be expensive for a new business yet there is plenty of data freely available (for example, surveys and reports published by trade journals, banks, the DTI and various trade associations).

At the end of the day, you must be able to convince others that you have a good product or service, it will do what you think it will and has been thoroughly tested. It should compare well against the competition on quality, price and performance.

Step Three: Finding the funding

Any business needs sufficient cash resources to finance its operations. The amount (or capital) required depends upon the nature of its activities, the scale of necessary expenditure on property, plant and equipment, development costs and its "working capital requirement".

At the outset, finance is likely to come from cash invested by the proprietors and borrowings from bankers or investment from other sources, such as Business Angels. As time goes by, profits can be retained to provide the finance to meet loan repayments and other needs.

Lenders will have to be satisfied that the business is viable and that it will be able to pay interest and make capital repayments as they fall due. They are also likely to look for some form of security, by way of a legal charge over the assets owned by the business or over assets owned by the proprietors personally.

Step Four: The Business Plan

Before approaching any third party for finance, you will need to estimate, as realistically as you can, how much capital you need and prepare a thoroughly considered "Business Plan". This should take the form of a written explanation of:

- The business activities
- Its future prospects
- Its strengths and opportunities
- Its weaknesses and threats and how they are to be managed.

A prospective investor or lender would expect this to be supported by detailed financial projections of profits and cash flows, explaining the underlying calculations and why the forecasts are thought to be achievable. Ideally these should be prepared on a month by month basis at least for the first year and in an annual summary form for each of the next four years.

A Balance Sheet Forecast should predict the state of the business' affairs at the end of each period for which profit forecasts are prepared.

Except for smaller capital requirements, you will need to take advice as to where to look for finance. Sources range from the straightforward bank borrowing to more complicated venture capital arrangements where lenders may be looking for an equity interest in the business on a tax efficient basis. There are also many organisations and individuals prepared to provide financial or other help to new businesses.

Step Five: Choose the right legal structure

The exact legal form your business will take is an important decision. It is one that should be made at an early stage and will be heavily influenced by the results of your planning work so far.

The legal structure of your business defines your own responsibilities to everyone who is associated with the business. You should seriously consider professional advice to help you with this decision. There are five basic ways of setting up in business:

- As a sole trader
- In partnership with others
- In a limited liability partnership
- Through a limited company
- As a franchise.

The following table summarise the main advantages and disadvantages of each.



| | Advantages | Disadvantages |
|--------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Sole trader | <ul style="list-style-type: none"> • Few formalities • More flexibility • Complete responsibility • Taxed as an individual, but slightly differently than an employee • Start immediately | <ul style="list-style-type: none"> • Personally liable for debts, although, total National Insurance cost is lower than for an employee, so are the benefits |
| Partnership | <ul style="list-style-type: none"> • Draw on talents of others • Relatively unrestrictive | <ul style="list-style-type: none"> • Share the profits and set up costs • Jointly and severally liable for business debts • Not in sole control • National Insurance similar to the sole trader |
| Limited company | <ul style="list-style-type: none"> • Not normally personally liable for company's debts • Enhanced business image | <ul style="list-style-type: none"> • More complex start-up procedure • More formal and restrictive • Cannot exceed powers granted by Articles of Association • Not normally allowed to borrow money from the company • Accounts may have to be audited if you exceed statutory audit threshold |
| Limited Liability Partnership | Similar to partnership, but: <ul style="list-style-type: none"> • Personal liability is limited unless responsible for partnership's bankruptcy | Similar to partnership, but: <ul style="list-style-type: none"> • Additional statutory requirements • Accounts may have to be audited if you exceed statutory audit threshold |
| Franchising and leasing | <ul style="list-style-type: none"> • Can trade on image and reputation of a household name • Need less start-up capital • Business risk may be reduced | <ul style="list-style-type: none"> • Licensor has degree of control over the way the business is run • Royalties have to be paid |

Sole trader

As a sole trader, you are self-employed for tax purposes and don't need any formal constitution for your business. You will have to prepare annual accounts as the basis of the profits to be included in your Self Assessment Tax Return, but those accounts do not need to be audited. You retain the profits from your earnings having made adequate allowance for tax. But:

- Your personal liability is unlimited if something goes wrong, although this can be mitigated by appropriate insurance cover

- If the business fails owing money, you could be declared bankrupt. Your creditors can take possession of all your personal property including your home and car
- You have only a limited entitlement to state benefits

Partnership

A partnership is similar in format to a sole trader except that you will be sharing your profits, as well as your workload and problems, with one or more people.

If you form a partnership you and your partners are individually self-employed for tax purposes. Although you aren't obliged to have any form of written "partnership agreement", you would be well advised to do so even if your business partner is your husband or wife. This can avoid any future argument about how you share the profits and help to resolve any disputes.

If the business makes a loss, you and your partners would each have to make good those losses. You and your partners are personally liable to your creditors for all the debts of the business. However, partners are normally "jointly and severally" liable, meaning that a creditor can claim in full against one or all the partners in the business. You are responsible for business debts run up by your partners even if you knew nothing about them, and each partner is responsible for the whole amount.

You can draw cash in anticipation of profits by agreement between you, but it is essential that you retain enough to pay your Income Tax when it falls due. In normal circumstances, tax is a personal liability of each of the partners, although it is usually paid by the partnership.

Limited company

Limited companies are incorporated under the Companies Act 1985. They are governed by that Act and by a myriad of case law and legal precedent. To form a limited company you only need one shareholder, one director and a separate company secretary.

Buying a company "off the shelf" from an agent is relatively cheap and has the advantages of speed and ease. The agent provides an already registered company, the Memorandum and Articles of Association and a Certificate of Incorporation. The Memorandum and Articles of Association set out the nature of the business and the way in which it will operate.

If you form a limited company you will be an employee of the company, probably as a director. All directors (even non-executives) have specific, statutory rights, duties and responsibilities with which you must acquaint yourself at the outset.

It is crucial that you fully understand the precise contractual status of everyone involved with the company. The shareholders, directors and the company itself are each separate people in the eyes of the law.

A contract entered into in the name of the company, is a contract between it and a third party. If something goes wrong, any complainants would have to sue the company, because it is the company that has entered into the contract. Normally creditors can claim only on the assets of the company, unless you have given them any personal guarantees. In this way, you can protect your personal possessions if the business goes bust.

You can extract the profits of the company either by way of a salary if you are an employee or by dividend if you are a shareholder. These have very different consequences for tax purposes.

On the downside:

- You have to have a legal constitution which is set out in the Memorandum and Articles of Association
- You need to prepare accounts in a prescribed, statutory format which have to be filed and placed on public record at Companies House
- You would normally have to have those accounts audited if the statutory audit threshold is exceeded.

Limited Liability Partnership

In broad terms this is a cross between a partnership and a limited company. You can organise your business and pay tax in exactly the same way as if you were an ordinary partnership, but:

- Your personal liability for debts of the business may be limited in certain respects. If a limited liability partnership is unable to pay its debts, you could lose any money you have tied up in the business at the time plus any amounts that you may have taken out of the business within the previous two years.
- If you are the partner responsible for the insolvency, you can be personally liable for all the debts of the partnership which cannot otherwise be settled from its assets
- There are a number of statutory reporting requirements that are similar to those for limited companies, including having to notify Companies House of the business address and the names of the partners, placing accounts on public record every year and having them audited if the statutory audit threshold is exceeded.

Franchising and leasing

Taking up a licence to franchise or becoming a distributor (which can be run as a sole trader, partnership or limited company) is an increasingly popular way of starting a business.

Before taking this route, you should check the track record of the franchisor by talking to other franchisees, reviewing bank status reports and audited accounts and ensuring that the franchisor has good publicity in the UK.

Franchising offers the unique opportunity of running and developing your own business using a product or service that is already successful, with financial and marketing support from a larger organisation. Because franchises have a higher survival rate than other business start-ups they are looked upon favourably by outside investors, particularly by the banks.

Step Six: Understand your new tax responsibilities

The Inland Revenue requires new business activities to be registered within three months of commencement. Failure to do so can involve penalties. A helpline takes registrations over the phone (08459 15 45 15). Those who register are issued with a Starting up in Business guide. There is also a free video. So, what are the comparative tax implications of using a limited company vehicle or not?

National Insurance and Income Tax

A sole trader or partner is charged Income Tax on the whole of the profits (or his partnership share) of the business for each annual accounting period. There is a further charge for National Insurance based on those profits.

Corporation Tax

Corporation Tax is charged on the profits, including capital gains, of a limited company for each annual accounting period. Those profits are struck after deducting all salaries (including any paid to proprietors and Directors) but before deducting dividends.

Taxable profits

The taxable profits of sole traders, partners and limited companies are not always the same as their accounting profits. There are certain expenses, which are not deductible for taxation purposes (e.g. entertaining and travelling expenses between your home and principal place of business).

Tax return

For both Income and Corporation Tax purposes, as an individual you are required to complete a tax return and calculate and pay the tax due under the "Self Assessment" arrangements. The Inland Revenue has the power to make enquiries concerning those tax returns and tax calculations.

If it is established that a tax return or tax calculation is incorrect, interest and penalties can be charged in addition to the amount of tax underpaid. Penalties are also charged for failure to submit a tax return by the due date.

PAYE Scheme

In the case of a limited company, you (possibly with others) own the shares in the company and you will probably be a director and, as such, an employee of the company. Your income from the company will be in the form of a salary and/or dividends.

For wages and salaries of any business paid to employees, arrangements will need to be made with the Inland Revenue:

- To set up a PAYE Scheme
- Deduct Income Tax and National Insurance contributions from payments to employees
- Pay those deductions plus Employers' National Insurance over to the Inland Revenue every month/quarterly.

The Employer's National Insurance charge is a deductible expense in computing business profits for tax purposes.

The total cost of National Insurance is lower for a sole trader or partner than is the case for an employee (including a director of a limited company) but so are the benefits should they be needed.

If a shareholder pays tax at "Higher Rates", there will be an additional charge to Income Tax on any dividends they receive in the tax year.

Make sure that you regularly set cash aside so that you have enough to meet tax liabilities as they fall due.

Value Added Tax

If your turnover exceeds the registration threshold, you will normally be required to register for and charge VAT on your income and pay it over, after deducting any VAT on allowable expenses, to Customs & Excise. They will also consider voluntary registration, which could benefit the business.

There are special schemes for smaller businesses including cash accounting and annual accounting, otherwise VAT is usually payable quarterly. Customs & Excise will carry out periodic checks of your accounting records and VAT Returns. Failure to make an accurate return, or pay the tax on time can result in estimated demands being made by Customs & Excise plus (possibly) penalties and interest.

Easing the tax burden

There are many ways in which your overall tax burden can be mitigated or remuneration packages can be organised to enhance the value to employees (including directors) whilst capitalising on the tax savings to the employer. These can be complicated issues and you should seek specialist advice.

Step Seven: Legal and commercial Considerations

There are many other issues, which you should familiarise yourself before embarking in business on your own. The following highlight only a few of the more important matters.

- **Legal agreements** – In any form of business venture you are bound, sooner or later, to become involved with formal contracts. It is essential that you get a lawyer to look at the small print of the more important legal agreements that you need to enter into.
- **Trading laws** – Whatever your business, there are three trading standards which are almost bound to affect you. If goods are faulty, customers can have a full or partial refund; goods must always live up to the claims you make for them and goods must meet certain safety standards. You should also familiarise yourself with the requirements of the Sale of Goods Act 1979 and how they affect your trading relationships with both customers and suppliers. It is worth checking with a solicitor to find out what affects you.
- **Stationery** – to comply with legal & VAT requirements, you will need to know exactly what can, must and cannot be included on your notepaper, invoices, statements etc. These vary according to the legal status of the business you have.
- **Protecting your intellectual property** – It is essential that you take steps to protect your rights to any original work, designs, inventions etc. of your own creation whether it be by way of patent, copyright or otherwise.
- **Insurance** – There are many types of risk that you can insure against but the following are, perhaps, the more important ones:
 - Public & Third Party liability
 - Employer's liability (a legal requirement)
 - Business interruption
 - Professional Indemnity
 - Theft or damage to assets
 - Key Man Insurance
- **The Data Protection Act** – this legislation seeks to control information about other people that you retain by way of any electronic or other medium, how you use it and the rights of others to demand details of information you hold about them. Make sure you know what is required.
- **Disaster recovery** – with all the planning in the world things can still go wrong. Always be prepared. Plan for all potential disasters, not just IT failures. Put arrangements in place to recover from them as soon and as best you can. Don't just assume that disaster recovery plans will work, test them out.
- **Employment law** – there is much legislation on employing staff. The more important issues include:
 - Public & Third Party liability
 - Written Terms of Employment
 - The Minimum Wage
 - Statutory Sick Pay
 - Maternity Leave
 - Redundancy
 - Health and Safety at Work
 - Stakeholder Pensions

Many employers take out an Employers' Protection insurance policy.

Step Eight: Establish basic accounting records

It is crucial, from the outset, that you maintain an adequate record of all your business transactions:

- To keep track of income and expenditure
- To provide sufficient information with which to prepare your income tax and/or corporation tax returns accurately and on time. The Inland Revenue requires you to keep records for at least six years to support the entries you have made in the tax return

- In the case of a limited company – to comply with the statutory accounting requirements
- To monitor the success of your business
- To provide the information necessary for you to plan for the future.

Initially your records can be kept using a simple spreadsheet program or they can even be handwritten on analysis paper. As your business develops, you will need to have more sophisticated systems such as an 'off the shelf' computer accounting package

Step Nine: Take advice

Your talents and skills should be exploited by you and not by others. It pays to take professional advice where necessary. Look for someone with the relevant expertise and with whom you feel you can build a relationship of mutual trust and respect. They should offer you commitment and understand your business and your long term objectives.

Step Ten: Enjoy it!

Deciding to run your own business is a major decision and one which should not be taken lightly. Although there are a significant number of serious issues to consider before you start, the experience of being your own boss can be immensely rewarding and satisfying.

Good luck.



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