

FINANCIAL CONSIDERATIONS

OF

STARTING A NEW BUSINESS

BY

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Introduction

Owning your own business is part of the American Dream. Intel, Microsoft, Mrs. Fields, and Disney, Ford - these are all enterprises that began with an individual's belief that they could do it their way.

No matter how beautiful the design, if a house is not built on a well-placed foundation, that house will eventually fall. So too, the success of a business can depend, in large part, on the financial foundation on which the business expects to run.

We live in a complex world of business and governmental regulatory bodies. Your goal is to succeed with your ideas while still complying with the rules and regulations of these governing bodies. We have written this handbook as a reference and tool for starting your own business. Your goal is to succeed; our goal is to help you attain that success.

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CHAPTER ONE – Choice of Entity

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

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

Sole Proprietorship

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

A sole proprietorship is perhaps the easiest form of business to own and operate because it does not require any specific legal organization, except of course, the normal requirements such as licenses or permits. A sole proprietorship typically does not have any rules or operating regulations under which it must function. The business decisions are solely the result of the owner's abilities.

Partnerships

Partnerships can take two legal forms, general or limited. In a general partnership, two or more individuals join together to run the business enterprise. A partnership must usually file a fictitious business name statement to operate a business under the partnership name. Each of the individual partners has ownership of company assets and responsibility for liabilities, as well as authority in running the business.

In a general partnership, the authority of the partners, and the way in which profits or losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of each of the partners for settlement of partnership debts.

A limited partnership is comprised of one or more general partners who are personally liable for partnership debts and one or more limited partners who contribute

capital and share in the profits or losses of the business. The limited partners do not take a part in running the business and are not liable for the debts of the partnership.

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

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

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

Limited Liability Companies

A limited liability company (LLC) is a separate legal entity that exists under the authority granted by state law. A LLC has substantially all of the legal rights of an individual and is responsible for its own debts. Typically, the members (owners) of a LLC are protected from the liabilities of the business. The legal protection afforded the members can far outweigh the additional expense of starting and administering a LLC. However, when a LLC is small, creditors often require personal guarantees of the principal owners before extending credit.

A LLC operates in a more formal manner than a sole proprietorship but generally less formal than a corporation. A LLC must adopt and file Articles of Organization. A LLC with more than member should have an Operating Agreement that spells out the rights and obligations of its managers and members.

If there is only one owner then the LLC is a disregarded entity for income tax purposes. The return it files is the same form its owner would file if the LLC did not exist. So if an individual owns the LLC then it generally files a Schedule C. A LLC with two or more members is taxed the same as a partnership. The elections made in a LLC's initial tax returns can have a significant impact on how the business is taxed in the future.

Should you decide to operate your business venture as an LLC, you should seek the advice of competent legal counsel and business-oriented accountants.

Corporations

A corporation is a separate legal entity that exists under the authority granted by state law. A corporation has substantially all of the legal rights of an individual and is responsible for its own debts. It must also file income tax returns and pay taxes on

income it derives from its operations. Typically, the owners or shareholders of a corporation are protected from the liabilities of the business. The legal protection afforded the owners of a corporation can far outweigh the additional expense of starting and administering a corporation. However, when a corporation is small, creditors often require personal guarantees of the principal owners before extending credit.

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

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

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

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

CHAPTER TWO- Tax Responsibilities

A significant task for the new business owner is assuring that the business properly complies with the extensive tax and information filing requirements imposed by various governmental agencies. Stiff penalties are commonly assessed if the required forms and returns are not properly prepared and filed in a timely manner.

While this chapter is not intended to be an all-inclusive list of the filing requirements, it summarizes some of the more prominent requirements common to most businesses. Many industries have specific filing requirements that are not part of this text, but which nevertheless, must not be overlooked. Professionals with experience in your industry should be consulted to ensure that any such filings are properly handled.

Internal Revenue Service

Most tax forms filed with the Internal Revenue Service require the use of a Federal Employer Identification Number (FEIN). This number is obtained by filing a Form SS-4 with the Internal Revenue Service. New corporations and partnerships should file a Form SS-4, and so should sole proprietors if they plan on hiring employees. You can download a copy of Form SS-4 from the Internal Revenue Service web site – <http://www.irs.gov/>.

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

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

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

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

TAX CALENDAR

<u>Date</u>	<u>Return</u>
January 31	Payroll tax return Property tax listing
March 15	Income tax return
April 15	Estimated income tax payment
April 30	Payroll tax return
June 15	Estimated income tax payment
July 31	Payroll tax return
September 15	Estimated income tax payment
October 31	Payroll tax return
November - December	Year-end tax planning
December 15	Estimated income tax payment

Sales tax returns are due on the 15th of the month following the month of sales. For example, January's sales tax return would be due February 15. Smaller companies may be able to file sales tax returns on a quarterly basis.

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

CHAPTER THREE - Accounting

Most operators of a new and growing business have a flair for the environment in which the business operates. They may be a great salesperson, an outstanding mechanic, consultant, lawyer, or inventor. Unfortunately most people don't like to keep the books. As an owner of a business you must remember that your company's books and financial statements represent a score sheet which tells how you are progressing, as well as an early warning system which lets you know when and why the business may be going amiss.

Financial statements and the underlying records will provide the basis for many decisions made by outsiders such as banks, landlords, potential investors, and trade creditors as well as taxing authorities and other governing bodies. The necessity for good, well-organized financial records cannot be over emphasized. One of the greatest mistakes made by owners of small businesses is not keeping good financial records and making improper or poor business decisions based on inadequate information.

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

1. Who will be the users of the financial information?
2. What questions do I need answered to manage the business?
3. What questions should be answered for government or regulatory taxing authorities?

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

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

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

1. Will your business have inventory to account for? If so, will it be purchased in final form or will there be production costs?
2. Are fixed assets a significant portion of your business?
3. Will you sell only one product or service or will there be several types of business?
4. Will you be involved in e-commerce?
5. Will you have accounts receivable to track?
6. Are you going to do business in only one location or will you do business in several states?
7. Are the products you sell subject to sales tax?
8. Do you need to track costs by department?
9. What type of government controls or regulatory reporting are you subject to?

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

Accounting Method – Cash or Accrual?

One of the decisions to be made as you start a business is whether to keep your records on a cash or accrual basis of accounting. The cash basis of accounting has the advantage of simplicity and almost everyone can understand it. Under the cash basis you are accounting for sales when you have received the cash and accounting for expenses when you have paid them. When counting the money in "the cigar box" at the end of the month, you will know how much money was made.

Unfortunately, as we all know, the business world is not always so easy. Sales are made to customers and you sometimes must extend credit. Your business will incur liabilities which are due even though you may not have received the invoice or have the cash available to pay them.

Most users of financial statements, such as bankers and investors, are accustomed to accrual basis statements and expect to see them. Once you become familiar with them, they provide a much better measuring device for your business operations than cash basis statements.

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

Recordkeeping

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

Very often the owners of a business decide to keep the books themselves and underestimate the commitment they have made to other phases of the operation and the time required to maintain a good set of financial records and books of account. As a consequence, the record keeping is often low priority and must be caught up later. This approach, though rarely planned, can require a substantial expenditure of time and money.

While it is important for the owners of a business to maintain control and stay involved in the financial operations of the enterprise, this can be achieved by maintaining close control over the check signing function and scrutinizing certain records. Your company's CPA can help develop a good program of record keeping duties for you, your employees and any outside bookkeepers or accountants you may engage.

The computer is probably the single most valuable invention for bookkeeping and accounting since the advent of double entry bookkeeping. If your business includes any of the following then a computer would be a useful tool in your business.

1. Many repetitious or routine tasks
2. Lots of paperwork; i.e., payroll checks, invoices, purchase orders, mailing labels.
3. Lots of general correspondence
4. Written reports, contracts, newsletters, catalogues or brochures.

There are a number of very good, easy to use accounting software systems that are commercially available, but none of them will solve the problems of inaccurate or sloppy financial records. All these programs will do is generate bad information faster. This is one of the reasons that the computer has also probably caused more headaches for the owners of modern businesses than any other single cause. If you want to use a computer based accounting package, either in your own business, with a service bureau or through your CPA, it is imperative that you generate accurate information to be entered into the system.

The real value of the computer becomes apparent once it is running smoothly in your business. Your CPA can then function in the capacity for which he was trained - not as a "number cruncher", but as your business advisor, consultant, and strategist. Both of you can focus not on producing reports for various regulatory agencies, but on analyzing your business to make it more profitable.

Internal Controls

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

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

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

1. When my company provides goods or services to our customers, am I sure that the sale is recorded and the revenue is recorded in accounts receivable or the cash is collected?
2. When cash is expended by my company, am I sure we received goods or services?

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

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

ILLUSTRATIVE CHART OF ACCOUNTS

Current Assets:

1110	Cash
1120	Temporary Investments
1130	Accounts Receivable
1139	Allowance for Doubtful Accounts
1140	Notes Receivable
1154	Interest Receivable
1170	Inventory
1190	Prepaid Rent
1191	Prepaid Insurance

Long-Term Investments:

1210	Land
1220	Investments in Bonds

Property, Plant and Equipment:

1310	Office Equipment
1320	Vehicles
1350	Software
1359	Accumulated Depreciation

Intangible Assets:

1410	Patents
1420	Goodwill
1430	Organizational Cost

Current Liabilities:

2140	Notes Payable
2130	Accounts Payable
2155	Salaries Payable
2160	Income Tax Payable
2170	Sales Tax Payable
2180	Payroll Taxes Payable
2195	Advances from Customers

Long-Term Liabilities:

2410 Mortgage Payable

Stockholder's Equity:

3510 Capital Stock
3511 Capital in Excess of Par Value
3610 Dividends
3650 Retained Earnings

Sales and Related Accounts:

4000 Sales
5170 Purchases
5178 Purchase Returns and Allowances
5179 Purchase Discounts
5200 Transportation In

Operating Expenses:

6001 Rent
6002 Advertising
6029 Depreciation Expense-Store Fixtures
6059 Depreciation Expense-Delivery Equipment
6070 Other Delivery Expense
6071 Transportation Out
6080 Salesperson's Commissions
6090 Miscellaneous Selling Expenses
6501 Office Expense
6511 Taxes, Other than Income and Payroll
6549 Bad Debts Expense
6555 Office Salaries
6585 Payroll Tax Expense
6591 Insurance Expense

Other Revenue:

7010 Rent of Land
7054 Interest Revenue

Other Expenses:

7154 Interest Expense

Income Tax:

CHAPTER FOUR – Payroll Taxes

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

Publications

Circular E, Publication 15, Employer's Tax Guide, covers the federal payroll tax reporting and deposit requirements.

Publication 583, Starting a Business and Keeping Records, provides basic federal tax and recordkeeping for people starting a business.

The IRS Publications can be obtained through the local office of the Internal Revenue Service, by calling 1-800-424-3676, or from <http://www.irs.gov/>.

NC-30, State of NC Income Tax Withholding Tables and Instructions For Employers, covers the NC payroll tax reporting and payment requirements and can be obtained through the local office of the NC Department of Revenue, by calling (919) 733-3261, or from <http://www.dor.state.nc.us/>.

Summary of payroll tax deposit/payment requirements

Federal income tax withheld and FICA taxes (employer and employee portion):

1. If at the end of the calendar quarter your total undeposited taxes are less than \$1,000, you may pay the taxes when you file Form 941, Employers Quarterly Federal Tax Return, but only if you would have otherwise been a monthly depositor (see number 2).
2. If at the end of any month your total undeposited taxes are \$1,000 or more, but less than \$50,000 in total during the prior year, deposit the taxes with a federal tax deposit coupon, at an authorized financial institution or Federal Reserve Bank within fifteen days after the end of the month.
3. If your total federal tax during the prior year was \$50,000 or greater, deposit the taxes for payrolls dated on Wednesday, Thursday and Friday by the following Wednesday and deposit taxes for payrolls dated on Saturday, Sunday, Monday, and Tuesday by the following Friday.
4. If your unpaid federal payroll taxes reach \$100,000, deposit the next banking day.

Many larger businesses are required to deposit their federal payroll taxes electronically.

State income tax withheld:

1. Every employer required to withhold NC income tax is required to file a return for each calendar quarter, except those required to file monthly. The return is due by the last day of the month following the end of the calendar quarter.
2. If at the end of any month your total unpaid income tax withheld is \$500 or more, file payroll returns on a monthly basis. The return and payment is due the 15th day of the month following the month in which the tax was withheld.

Unemployment taxes:

To determine your quarterly liability for FUTA, multiply by .008 that part of the first \$7,000 of each employee's annual wages that you paid during the quarter. If the resultant liability for the quarter is \$100 or less, there is no requirement to deposit it currently. Instead you merely add it to your liability for the following quarter.

If your liability for any calendar quarter (plus any undeposited taxes for an earlier quarter) is more than \$100, you are required to deposit the taxes with a federal tax deposit coupon, at an authorized financial institution or Federal Reserve Bank by the end of the following month.

If the tax reported on your Federal Unemployment Tax Return, Form 940, less deposits for the year:

Is more than \$100, you must deposit all of the tax by January 31, or,

Is less than \$100, you may pay the taxes when you file Form 940.

To determine your quarterly liability for SUTA, multiply by your assigned rate (maximum of 2.700%) that part of the taxable wage base (the 1989 taxable wage base is \$10,700, the wage base is adjusted annually) of each employee's annual wages that you paid during the quarter. The quarterly return is due by the last day of the month following the end of the calendar quarter.

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

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

Withhold at a flat rate of 28% for federal and 6% for North Carolina, or,

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

As of 2000, gross income does not include any fringe benefits that qualify as one of the four categories listed below. Fringe benefits that qualify for the exclusion are exempt from income tax and Social Security tax withholding (FICA and payment of Federal Unemployment Tax (FUTA)). Conversely, benefits that do not qualify are subject to these taxes. An example of a common non-qualifying benefit subject to tax is the automobile allowance.

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

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

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

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

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

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

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

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

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

Social Security Tax (FICA) 2000

Tax rate for employer	7.65%
Tax rate for employee	7.65%
On wages not to exceed	\$76,200.00
Maximum employee contribution	\$5,829.30
Maximum employer contribution	\$5,829.30

Federal Unemployment Tax (employer only)

Gross federal tax rate	6.20%
Less credit for North Carolina UI (If timely payment is made)	5.40%
Net federal tax rate	.80%
On Wages not to exceed	\$7,000.00
Maximum employer contribution (per employee)	\$56.00

CHAPTER FIVE – Tax Year-End

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

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

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

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

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

The election of a year-end is made on the first tax return of the corporation. Even though the corporate by-laws disclose the fiscal year and the request for Federal Identification Number (Form SS4) asks for the year-end, a final election is not made until the tax return is filed. There is not a separate form for making the election. The corporation merely states the fiscal year on page one of Form 1120.

There are two important requirements for making the fiscal year-end election. First, it must be made on a **timely filed** (including extensions) return. If the first return is not timely filed, the year-end of the corporation is, by default, December 31. Secondly, the first year cannot be longer than twelve months. For example, if a company is incorporated on June 25, and wants to select a June year-end, it must file

a return for the five-day period, June 25 through June 30. Otherwise, the first return would be for twelve months and five days, which is not allowed.

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

Certain corporate events will require a change of year-end. For example, if another corporation acquires the company's stock, the acquired corporation will be required to use the same year-end as the parent company. Also recent tax law changes mandate that, in most cases, S-Corporations and many personal service corporations use a December 31, year-end.

CHAPTER SIX – Income Taxes

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

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

Corporation. A corporation is considered a taxable entity and is required to file a federal Form 1120 and a comparable state form (e.g. North Carolina Form CD-405).

Partnership. A partnership is not a taxable entity. It is treated as a conduit through which taxable income is passed to the individual partners for inclusion in their respective tax returns. The partnership is required to file Federal Form 1065 and a comparable state form (e.g. North Carolina Form D-403A). Generally no tax is due with these forms, however, included with the forms is a schedule K-1 that lists the various items of income and credits to be included on the individual partner's return.

S-Corporation. An S-Corporation is a type of corporation that is specially treated under the federal tax laws. Some states (including North Carolina) follow the federal law pertaining to S-Corporations and others do not. The federal government taxes this type of entity in the same manner as a partnership, with certain exceptions. The S-Corporation is required to file Federal Form 1120S and a comparable state form (e.g. North Carolina Form CD-401S).

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

Estimates

In addition to the regular tax forms the law requires that if an estimate of the tax is not properly prepaid on a quarterly basis, a non-deductible underpayment penalty will be levied. Since an estimate is based on forecasting the future, and liable to human error, the tax laws provide two safe-harbors to avoid the penalty for underpayment. If your payments for each quarter equal the lesser of 100% (for higher incomes this percentage is higher) of the prior year's tax or 90% of the current year's

tax, then the penalty can be avoided. (Note: There are some exceptions to these rules for corporations)

Corporate Federal: Tax deposit form deposited with your bank or paid electronically.
North Carolina: Form CD-429

Individual Federal: Form 1040ES
North Carolina: Form NC-40

Due dates of the various income tax returns are:

Corporate

Due the 15th day of the 3rd month after the end of the tax year. The estimated payments are due the 15th day of the 4th, 6th, 9th and 12th months of the tax year.

Partnership

Due the 15th day of the 4th month after the end of the tax year (April 15 for most partnerships).

Sole Proprietorship

Due April 15th. Estimated tax payments are due quarterly on April 15th, June 16, September 15, and January 15.

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

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

1. Election to capitalize and amortize costs incurred to organize the business. These can be legal, accounting or similar fees paid to commence operations. Such costs are not normally considered expenses of the corporation and are not deductible unless this election is made.
2. Election of a year-end. (see Chapter five for more information)
3. Election of an accounting method. (see Chapter three for more information)
4. Election to amortize start-up costs; otherwise these costs are not deductible until the business is terminated.

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

- a. Net-operating loss carryovers
- b. Research and development tax credits
- c. Business energy tax credits

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

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

Conclusion

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

CHAPTER SEVEN – Cash Flow

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

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

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

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

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

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

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

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

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

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

Additionally, you need to know the credit trade terms your vendors are willing to advance to you. Do you have to pay for inventory items on a C.O.D. basis or can you pay for them thirty or forty-five days after receipt? What expenses must be paid to allow you to convert purchased merchandise to salable inventory? If your production requires utilities to run machines or supplies, such as dispensable chemicals or packing materials that must be purchased prior to the sale of the inventory, you should factor in the timing of payment.

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

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

purposes. Will you have to buy or rent furniture? Will you need to make tenant improvements or pay deposits for utilities and other services?

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

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

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

Cash flow projections can be very slow, time consuming and tedious to undertake. It is often very tempting to hire someone else to prepare the projections for you. There are a variety of individuals who can help you do this, but the critical factor is that they only **help**. You as the owner and operator of the business are the only one truly qualified to develop your cash flow projections. You know what it takes to open and operate your business. Certainly a trained professional can offer guidance and ask pointed questions to be sure you are considering all of the necessary and sometimes hidden costs of operating a business. However, the more effort you put into developing the cash flow projections the more accurate they will tend to be. This exercise may also help you to pinpoint areas of potential cash savings that you had not otherwise considered.

CHAPTER EIGHT -

Obtaining Credit And Financing For Your Business

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

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

How do I get the money?

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

1. How much cash do I need?

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

2. What will you do with the money?

One of the most important questions you will have to answer for a potential investor is how the money will be spent. Will you use it for equipment or to hire additional employees or perhaps for research and development for a new

improved product? Again, part of the answer on how you spend the money is how it will benefit the company.

3. What experience do you have in running your business?

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

4. What is the climate for your type of business and your geographic location?

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

Once you have developed concrete answers to these and other pertinent questions, you can begin looking for financing. One of the first steps is to determine whether to raise funds through debt or equity. There are positive and negative aspects to each type of capital. The cost to your company of each type of funding is different as is the way in which they are treated for income tax purposes.

The interest on borrowed money is deductible by a business for income tax purposes, which reduces the effective cost to your company. Dividends, which you might pay on the same investment in stock, would typically not be tax deductible by your company. In selling stock there usually is no firm commitment by your company to pay the money back but your stockholder will want and generally will have a legal right to have a voice in the management of your company.

When you have made the decision as to the type of financing you think is appropriate to fit your desires and needs it is probably a good idea to consult with your CPA as to alternative types of debt or equity financing available.

Financing alternatives

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

In the summary we will only mention a few of the more conventional methods for a young company to obtain capital, though the possibilities are many. A good business

oriented CPA can discuss these and other alternatives in greater detail.

Debt financing sources

Banks. The first source of funds that typically comes to mind when borrowing money is a bank. That is why they are in business. Banks typically lend to small businesses on a secured basis using equipment, inventory or accounts receivable as collateral. The more liquid and readily salable the assets you have to offer as security the more acceptable they are likely to be to a banker. Loans from a bank may take several forms such as:

1. A line of credit which renews annually and allows you to borrow up to a predetermined maximum as you need it and pay it back as funds from sales and receivables are collected.
2. A short-term demand note which is payable in full on a specified date.
3. A term loan for the purchase of a specific asset such as a computer or a machine.

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

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

Trade credit. A very important source of financing for your company may be from the vendors and suppliers with whom you do business. Many suppliers will originally ask for cash on delivery or in some instances they want payment before starting on your order, depending on the nature of your purchase. Most suppliers will quickly establish trade credit with you once you have gained their confidence by continuing to do business with them and paying as requested.

Establishing good relationships with trade creditors is essential because it allows you to use the goods and services in your operations and sell your product to your customers, in some instances before you pay for them. Other vendors will rely upon the trade credit you build today as you attempt to establish yourself with them. Trade credit terms will vary depending on the type of purchase you make, the industry you are buying from and the industry you are in.

Equity financing sources

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

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

The price of venture capital financing is usually very high when compared to borrowing money from a bank, but it must be remembered that venture capitalists are dealing with much higher risk situations than commercial banks will finance. The cost of venture capital is measured in terms of the portion of your company you must sell to obtain the level of financing you require.

A venture capital firm sometimes requires a 300 to 500 percentage return on its investment over a four to five year investment period. While this may seem like an enormously high return, a venture capitalist is in the risk business and the return on a good investment must help offset those companies that do not meet their projections or fail altogether. To determine the price of such financing, a venture capitalist will start with the amount of financing you require and calculate what he must receive at the time his investment will be sold to allow him to achieve the rate of return he deems necessary.

Based upon the operating projections you provide, discounted based on his experience, he will estimate what your company might be worth at the time his investment will be liquidated. This might be at the point of a public offering or a sale to a corporate investor. The last step for a venture capital company in determining pricing is to calculate what percentage of the company he must own to realize the return he desires. At this point, the "horse trading" generally begins.

As a general rule you will want to retain as much of the ownership of the company as you can. The venture capitalist wants enough ownership to achieve his investment goals and have some control over how his money is spent. This will often be achieved by voting power and representation on the Board of Directors. At the same time a venture capitalist wants to be sure there is sufficient reward in the company for you and your management team to be motivated and achieve the projections in your business plan.

An individual or group of individuals with a strong background in business and management often manages a venture capital company. They can often provide depth

of experience and management assistance in areas where your management team may be weak. A venture capital group can very often provide contacts and valuable introductions in your industry. Remember a venture capital investor becomes a member of your team.

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

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

CHAPTER NINE - Insurance

Business insurance, like many types of expenditures, is one of those items that business owners typically do not like to pay. You must remember that sufficient insurance can be as critical to the success of your business as a good product or service. Without proper insurance you could lose all of the money, time and effort you put into your company.

The types and amounts of coverage you purchase must be evaluated on a cost-benefit basis like any other commodity that you purchase. Your CPA and insurance agent can help you review the amount of coverage you may wish to purchase for various purposes. Usually, you will want to insure against risks that could have significant detrimental impact on your business. This normally would include such items as fire, storm damage, theft, general and product liability.

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

Required policies

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

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

Other types of policies

Business Interruption. This coverage, as the name implies, covers the loss of revenues your business would generate if you were forced to shut down for reasons

beyond your control. While this is obviously valuable insurance, the policy premium must be carefully considered relative to the potential profits your business might lose during a short shutdown of operations.

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

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

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

CHAPTER TEN – Selecting Professional Advisers

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

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

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

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

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

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

CONCLUSION

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

Tax and Business Links

American Institute of CPAs	http://www.aicpa.org/
Bureau of Labor Statistics	http://www.bls.gov/blshome.htm
Edmundson & Company, CPAs	http://www.nccpa.com
Employment Security Commission – NC – Employment and Unemployment Services	http://www.esc.state.nc.us/
US Government Links Page	http://www.firstgov.gov/
Internal Revenue Service	http://www.irs.gov/
Library of Congress – Business Reference Services	http://www.lcweb.loc.gov/rr/business/brs.html
NC Department of Revenue	http://www.dor.state.nc.us/
NC General Assembly	http://www.ncga.state.nc.us/
NC New Hire Reporting	http://www.ncnewhires.com/
NC Secretary of State	http://www.esc.state.nc.us/
Tax and Accounting Sites – extensive list of links	http://www.taxsites.com/
Tax & Wage Reporting	http://www.treas.gov/stawrs/
US Securities and Exchange Commission	http://www.sec.gov/
Wake County	http://web.co.wake.nc.us/