

The Technology Entrepreneur's Guidebook

**Nasdaq
Indian CEO High Tech Council
U.S. Chamber of Commerce**

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Forward

Why another guidebook for entrepreneurs? Because the market has changed dramatically in the past few months and many of the rules are different. We set out to prepare a primer for entrepreneurs that reflects the new paradigms in the world of technology. Our objective is to provide up-to-date, practical information to new entrepreneurs that is based primarily on the real world experiences of successful technology executives and venture capitalists--not by people with only an academic understanding of entrepreneurship.

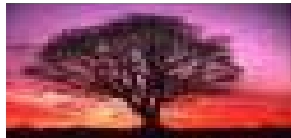
We have been deliberate in selecting authors who have meaningful insights into issues that matter to early stage entrepreneurs and have attempted to keep the topics as clear and concise as possible. We genuinely want to help new entrepreneurs achieve success and keep the technology revolution alive.

This guidebook is not meant to be a comprehensive treatise on entrepreneurship for technology companies. Instead, it is meant to provide only the basic information that we believe is most helpful to start-up technology ventures. We encourage new entrepreneurs to seek out other information on the Web or in bookstores, as knowledge is half the battle.

This is a very exciting time for entrepreneurs because technology is evolving so quickly and new market opportunities are being created everyday. The capital markets may not be as robust as they once were, but there still is an abundance of investment money out there waiting for a smart business plan to come along. We believe that fundamentally good business plays founded on strong technology will always be in demand. Our hope is that this guidebook will help ensure that some of these fundamentally good business plays grow into tomorrow's Ciscos, Microsofts, or Celeras.

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ENTREPRENEURSHIP



Entrepreneurship

By Reggie Aggarwal and Mark Esposito *

Entrepreneurship is a way of life. It is a driving force that compels you to do more, move faster, and go farther than anyone else, even in the face of high risk and uncertain outcomes. Unmistakably, the rewards of entrepreneurship, especially in the technology arena, can be great. But it is not an easy road to travel. Consider the following five facts:

1. Only 1 in 6,000,000 high-technology business ideas wind-up in an IPO;
2. Less than one percent of business plans received by venture capitalists get funded;
3. Founder CEOs typically own less than 4 percent of their high tech companies after an IPO;
4. 60 percent of high tech companies that are funded by VCs go bankrupt; and
5. Most high tech companies that succeed in having an IPO take between three and five years to get there.¹

Clearly, it is not easy to be a technology entrepreneur. Many successful entrepreneurs have failed at one point or another. And most have experienced a healthy dose of frustration, burnout, and sorrow along the way.

So why become an entrepreneur? For the true entrepreneur, that is a rhetorical question. For the emerging entrepreneur, there are at least three major reasons. First, there is the objective of creating something novel and useful. “To be on the cutting edge” is a necessary mantra.

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A technology entrepreneur generally seeks to solve a problem that exists in the market. Whether that means developing a better communications resource tool, a better optical switching device, or a better bioinformatics system, a void is always identified and then attempted to be filled. Too many people confuse this process with the process of identifying hot technology companies in the market and building new companies that mimic them. The hot technology companies are hot because they seek to solve a problem. Those that mimic them neither identified a problem nor created a solution; they simply found a new trend that they wish to follow.

The ability to maintain a sustainable competitive advantage over others is what brings rewards to the entrepreneur. The reason for taking risks fundamentally is tied to this concept. That is why being on the cutting edge is so critical to the entrepreneur.

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¹ John L. Nesham, High Tech Start-Up, pages 1-3, The Free Press (NY,NY 2000).

A second objective of the technology entrepreneur is to build long-term value. Sustainability is crucial. The would-be entrepreneur often confuses this concept with building “valuation.” Those who build companies for the primary purpose of attracting investment dollars at high premiums are opportunists, not entrepreneurs. The entrepreneur always is focused on creating something of lasting utility.

This does not mean that the entrepreneur is not concerned with attracting investment dollars or creating wealth. Rather, the entrepreneur’s strategy is to create long-term value and thereby ensure wealth. The trick is to not put the proverbial cart before the horse. Concentrating on long-term value can create wealth; concentrating on wealth typically creates neither value nor wealth.

A third objective of the entrepreneur is to have freedom. Being your own boss has definite appeal. Glass ceilings cease to exist and achievement is limited only by imagination. Entrepreneurs are motivated by having control over their work and the flexibility to pursue their dreams. But freedom always has a price. With greater personal freedom, comes greater uncertainty about the future, particularly in relation to finances. Greater personal freedom also means a less structured environment, in which greater self discipline is required in order to thrive. Entrepreneurs are willing to accept these risks, though, because of their absolute conviction that they have what it takes to overcome any odds.

If achieving these three objectives is not of basic interest, then the very thought of becoming an entrepreneur should be extinguished. If a big personal cash payout seems to be glaringly missing from the list of major objectives, it is because it is not a primary motivating factor. These three major goals are not shared by all and are inappropriate for many. Only those that find these objectives to be self-evident should embrace entrepreneurship.

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But what makes an entrepreneur special, besides believing in major common objectives? There are several characteristics that define the entrepreneur. For example, entrepreneurs always have passion. Entrepreneurs live and breathe their business enterprises. They are zealots about their business models and are evangelical about their products or services. They have to be. If they weren’t, the stress and financial pressures of running a fledgling business would completely wipe them out. The sheer magnitude of the odds that are stacked against entrepreneurs requires a special kind of irrational exuberance to overcome. Entrepreneurs have unshakable confidence in and enthusiasm for their business ventures that contagiously spreads to their business team.

Laser focus is another feature of entrepreneurs. There are many people that are creative, but lack discipline. Entrepreneurs, on the other hand, have both qualities. An entrepreneur identifies a path towards a solution and follows that path, notwithstanding the frequent temptation to take sideroads leading to seemingly newer, more exciting destinations. The entrepreneur knows that most of the journey down the chosen path is checkered with drudgery, yet continues down the path unswervingly, confident that there will be a reward at the end. The entrepreneur also knows that the sideroads

encountered along the way may appear appealing at their start, but will quickly become as checkered with drudgery as the originally chosen path and likely lead to a dead end. Focus and perseverance guide the entrepreneur.

Courage is a defining trait of entrepreneurs. To understand the odds against success and still forge ahead, knowing that many battles will be lost along the way, requires a certain amount of fearlessness. Entrepreneurs are purposeful in their tactics and can think on their feet. Yet they regularly face daunting challenges whose failure to overcome will spell certain disaster for their business ventures. Their ability to face these challenges without fear enables entrepreneurs to succeed where others cannot.

Entrepreneurs also are leaders. Contrary to the popular belief that entrepreneurs are mavericks who prefer to be lone wolves, entrepreneurs are visionaries that can inspire and lead their colleagues. There are few things more compelling than people who are passionate about their work, have the discipline to achieve success, and are fearless in their outlook. An entrepreneur builds teams and instills confidence in others.

Finally, an entrepreneur always is thinking ahead, perpetually in motion towards well defined goals. In the end, entrepreneurs can best be described as ocean waves, existing only so long as they move forward.

**A SENSIBLE APPROACH TO WRITING
A GOOD BUSINESS PLAN**



A Sensible Approach to Writing a Good Business Plan

By Mark Jauquet*

Writing a good business plan is important for two main reasons: (1) it requires you to analyze whether your business proposition objectively makes sense; and (2) without it, obtaining funding is unlikely. A business plan not only tells the story of your business idea, but also tells the unwritten story about how thoughtful you are as a business person based upon how you write it. Serious effort and consideration should go into this document. What you put into the plan is what you will get out of it.

Having said that, know that most investors only briefly glance at business plans and carefully read only those sections that interest them. Keeping a business plan short and direct will help ensure that the most important parts of your story are communicated. If an investor has to search through lots of superfluous text to find the kernel of information sought, odds are the investor would rather spend time on someone else's more succinct business plan. Take careful measure of what you opt to include in your business plan. If a particular issue is critical to your story, keep it. If the issue only marginally adds value, omit it. This requires discipline, as it is much harder to write a short, incisive business plan than a long, indiscriminately inclusive one. If your plan exceeds twenty-five pages, it's probably too long.

A good business plan should consist of several separate parts, each of which is capable of being read alone, but which together tell a comprehensive story about what your business proposition is. The parts each should be written in simple language, with a premium on brevity. Preferably, the plan should be formatted as follows.

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Executive Summary

An executive summary should clearly summarize all of the major points of your business plan. Ideally, it is one page long and should never be more than three. The best executive summaries have "text boxes" that identify: (i) the basic business concept; (ii) the capital needed; (iii) the use of the cash proceeds; (iv) the cash raised to date; (v) the size of the market in annual revenues; (vi) the domain experience of senior management; (vii) any barriers to entry; (viii) major strategic relationships; (ix) revenue/profit projections for three years; and (x) the exit strategy.

Keep in mind that investors typically only skim executive summaries looking for key facts related to their investment criteria. If they don't get most of the information they are looking for in under one minute, your business plan has high chances of being filed under "never."

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Company Description

If an investor reads this section, it is because they already have developed some interest based on the executive summary. Use this section to fill in the larger picture of what your company's vision is and how it will meet its goals. Be sure that your mission is well defined and realistic. Statements like "we wish to be the dominant player in our industry sector" without any intermediate steps identified will turn people off.

Be sure to explain what your company does or plans to do. If it develops a product or provides a service, define it concisely. Keep in mind that you will have an opportunity to explain the product or service in more detail later on. In this section, you need to provide only enough information to satisfy an investor that you have an exciting offering and have a solid business model built around it. This section ideally should answer the questions what, why, and how from a "10,000 foot fly-over" perspective.

Market Size

Business models that only can leverage small economic niches will not appeal to most investors, even if the technology is fantastic. Investors take risks for one reason--to make big returns. Your market space must be large enough so that even if you only get a small piece, you still have the potential to generate very large revenues and make big profits ("large" and "big" here means at least the hundreds of millions, preferably billions, of dollars). Your business model also should be easily scalable to take advantage of other markets.

When you describe your market, be realistic. Statements like "ABC Consultants predict that the market space will approach \$4 trillion by 2005" will get you nowhere. Make sure you define your space more narrowly so investors know that you have studied your industry and pragmatically identified your real target market. While describing your market space, be sure to clarify what opportunity is available for exploiting and how your business model will do it.

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Technology Description

If you have developed a new technology, explain what it is in readable terms. Keep in mind that investors cannot have detailed understandings of all technology sectors and may not be well-versed in your company's particular space. Many entrepreneurs make the mistake of getting too detailed about their technology in their excitement to describe all of its benefits. Others make broad-sweeping statements that their technology will change the world, without giving any credible description of how and why. Balance is the key. Graphics are often helpful.

As you describe your technology, make sure you connect your explanation with the market opportunity you have identified and your corporate vision. To an investor, technology is only interesting if it has a business purpose and fills a market need. Remember, you are writing a business plan, not a publication in a technology journal.

Competition

If you have chosen an attractive market space with a real business opportunity, then you generally should have limited competition. After all, if there are many companies pursuing exactly what you plan on doing, where is the market opportunity?

Once you have identified your competitors, communicate why you are different and better. Just as importantly, describe what barriers are present that will keep your competitors from eating your lunch. As you analyze this, keep in mind that your competitors are not just the companies that presently are in your market space, but also the giant corporations that could jump into your space if you inadvertently show them where an opportunity lies. Behemoth companies often enter markets late, but quickly dominate because they have the resources and contacts to accelerate past the early entrants.

Being first to market can be a significant competitive advantage, but only to the extent that you have such a big lead that the behemoth corporations and others can not catch up before you already have swallowed a major market share. Tying up with an industry giant, of course, also can be a major competitive advantage for the same reason that not tying up is a major competitive threat. Patents and other intellectual property protection also can give you a substantial edge, but only if there is real substance supporting them. Many entrepreneurs rely upon software “methods of doing business” patents, which most investors frown upon as impotent. “Patent pending” status similarly is viewed as fragile shielding. If intellectual property protection is a major part of your competitive advantage, be sure that your intellectual property rights are compelling, defensible and very difficult to “engineer around.” A consultation with an investment banker on the value of intellectual property often is more instructive than one with a lawyer.

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Sales/Revenue generation

This section, along with the financials, often gets looked at before any other part of the business plan. Investors, many having been burned in the past by technology companies with no hopes of ever generating revenues, much less profits, are especially wary about how prospective investment opportunities will make money. This is where an old-fashioned, common sense approach comes in handy. Explain in believable terms how your company will swell its coffers. Include information about direct sales and channel sales strategies, pricing, business volume, advertising, public relations, and all other matters that will contribute to your top line revenues. Correlate these details with the market opportunity and your competition. Remember, your revenue generation plan is something your investors will expect you to execute, so keep it within your actual means.

Finances

This is the most important section of the business plan. Here is where you explain how your revenues are offset by your expenses and how you ultimately will generate a profitable, self-sustaining enterprise. If the last clause of the preceding sentence is not part of your short term objectives, stop reading now--come up with a new idea and then start at the first paragraph again.

When describing your financial projections, do not put in anything that an objective person will not believe. Sounds simple, but there are thousands of business plans floating out in Never-land that show a million dollars in revenue in year one and one hundred million in year two. Old school economics, please. Investors want to know that you have sound financial judgment and realistically know how to make a buck.

Detailed projected profit-and-loss statements, cash flow statements and balance sheets are very helpful. Healthy use of charts is encouraged. All should be formatted in accordance with traditional accounting standards. Also, be sure to explain the underlying assumptions behind your financial projections and to conduct a sensitivity analysis based upon lower revenue and “worst case” scenarios.

Management

There is an old adage that “nothing succeeds like success.” Loosely interpreted, this means that track record counts. Investors prefer to put money in businesses that are run by world-class management teams with substantial domain experience. Seasoned executives can steer fledgling companies through choppy waters where novices might run aground. Moreover, seasoned executives have contacts and relationships that allow their companies to grow quicker and more stably.

In this section of your business plan, carefully explain the track record of your management team as it pertains to your current business venture. Investors need to have comfort that they will be entrusting their money to people who can execute the business plan, not just write it. Acknowledge weaknesses if you have them, but explain how they will be overcome with future hires.

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Perhaps the strongest measure of the management’s commitment, as viewed by investors, is the risk they have taken to join the company. If your management team members are all working “day jobs” until the capital is raised, the capital is unlikely to come. It is easy to say that management will quit their current jobs when the company is funded, but that means that the management is unwilling to take a risk before the investor does. Not very inspiring. Investors want to know that the management is willing to endure hard times for the company if necessary and believe in the business model fervently enough to throw away perfectly good careers.

The foregoing is generally all that needs to go into a good business plan. Of course, appendices that contain endorsements from clients, positive press coverage of the company, or other reference material always can be added. Some basic items that you should make sure are in your business plans are contact information (phone, address, e-mail, contact person) and a table of contents. These are simple features that will make it easier for an investor to review your plan and get in touch with you if they like it. Making an investment appealing starts with making it easy for the investor.

There are a variety of software products and templates available to help you develop your business plan. These can be helpful for pointers on structure and content, but don’t rely to heavily on them. The business plan must convey your personal excitement about the

opportunity being presented, which can only be expressed in your own words. Believe in yourself as you write your plan. Only then, will others follow.

RAISING VENTURE CAPITAL



Raising Venture Capital

By Lynn Metzger*

Raising venture capital is not for the faint of heart. You must be able to handle rejection well, as you will get plenty of it, and be comfortable under cross-examination. You must have faith beyond reason and energy beyond constraint. Getting funding from venture capitalists is an arduous process that will require you to undergo a great deal of self-examination and outside criticism, which you must endure, accept and incorporate. The process also forces you to relinquish some control over your business and consent to the advice and suggestions of your investors.

On the other hand, raising venture capital can be extremely rewarding if you are successful and an excellent learning experience if you are not. The process will require you to become disciplined and focused on bottom-line business objectives. It's a bit like boot camp, preparing you for the real battle ahead of building your company.

In order to understand the process of, and succeed in, raising venture capital, there are a few issues that you should consider carefully. Be sure you understand what venture capitalists need, how to approach them and how to evaluate them if you are fortunate enough to have a choice between potential investors. Armed with this information, you will be well prepared for the challenges that await.

Understanding Venture Capitalists' Needs

The first step in raising venture capital is to understand what venture capitalists are looking for. Unless you know what your target looks like, odds are you won't hit it. Keeping this in mind, know that venture capitalists care about the following:

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Financial considerations

Bottom line issues trump everything in the world of venture capital. This should be of no surprise, particularly given the harsh reminders that many venture capitalists recently received through the drubbing of their dot com investments. But nevertheless some of the financial details that venture capitalists concentrate on are worth highlighting. When venture capitalists look at the financial underpinnings of a potential investment, they typically consider: (i) the company's gross margins from the sale of products or services; (ii) the size of the company's market in annualized revenues; (iii) the company's revenue projections and associated sensitivity analysis; (iv) the time until the company achieves profitability; and (v) the company's need for follow-on capital.

Gross Margins: Gross margins are important to venture capitalists because they directly impact the company's liquidity. Typically, gross margins from a company's sale of products or services of less than 50% are considered unfavorable. Thinner margins may be acceptable to a small business owner who is simply trying to eke out a living, but they

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leave precious little wiggle room when markets dip into troughs. Moreover, the smaller the margins, the higher the risk for a future acquiror of the company and the less likely the company will get sold or have a successful initial public offering. If your business model does not aim for gross margins of 50% or higher, venture capitalists are unlikely to be impressed.

Market: The size of a company's market provides the contours for the future potential of the company. A company that has a small market opportunity, even if it captures the entire market, will still only be a small company. Venture capitalists prefer opportunities with relatively unlimited growth prospects. Typically, venture capitalists frown on business models that cannot be scaled into billion dollar markets. Only big plays can provide big returns.

Revenues: A company's revenue projections are key to a venture capitalist's evaluation of how the company will make money. Not long ago, making money was considered subordinate to increasing valuation. Now that normalcy has returned in capital markets and valuations are tied to revenue and profit potential, a company's ability to bring home the bacon is high on the list. Importantly, venture capitalists are careful to look behind the numbers and not simply accept projections at face value. Blanket statements that you plan on taking over 10% of the total market space given enough time and money will be ignored. Venture capitalists want to see credible plans for how you will generate revenues and what the company's earnings will look be if actual revenues are only 75%, 50% or 25% of projections.

Profitability: Directly related to revenue projections and gross margins is profitability. Venture capitalists want to see that you have thought about profitability and have a plan to get there--and soon. This means that increases in revenue generation cannot come through unchecked expenses in marketing or through other "revenue buying" schemes. Typically within three years, venture capitalists want to see your company's income consistently exceed its expenses.

Capital Needs: Venture capitalists plan for the future and expect prospective portfolio companies to do the same. That means that venture capitalists want you to show them that you know what your capital needs will be now and in the future. Consideration must be given to getting profitable quickly, but without sacrificing your company's growth potential. Believe it or not, venture capitalists want to make sure you have enough capital to grow aggressively, so long as your growth plans are consistent with profitability. They also want to know whether they are about to plunge into a bottomless money pit.

Liquidity

Arguably, liquidity should be included as part of the financial considerations above, but because it is so singularly important, it has its own section. Ultimately, venture capitalists are in the business for one reason--to generate aggressive cash returns for their investors. Most investors in venture capital firms expect cash repayment of their principal investment within a few years, and cash profits to be paid out over

approximately ten years. Venture capitalists, therefore, must oblige by investing in only those opportunities that will enable them to achieve full liquidity within three to five years. Further, venture capitalists generally shoot for returns of ten times their investment or more in order to compensate for some inevitable losses along the way. If your business model will not provide this kind of liquidity in this time frame, venture capitalists will look elsewhere for opportunity.

Management strength

Many entrepreneurs believe that venture capitalists look for investment opportunities by identifying exciting new technologies. This is incorrect. Most venture capitalists look for investment opportunities by identifying excellent management within specific technology sectors that are appealing. If they happen to have developed incredible technology, all the better.

Fundamentally, venture capitalists are more concerned with the execution of an idea than the grandiosity of an idea. That's why management is so important. Venture capitalists will take a great deal of interest in the domain experience of your management team and its track record. It's easy to say you can deliver; it's another to prove it by past history. Make sure you can show venture capitalists that your team has the necessary experience and know-how to achieve the results you are promising.

Technology

The type of technology product or service that you plan on offering must be useful, above all else. If it is also novel, proprietary, and in a red-hot market space, that's good too. In evaluating your technology, venture capitalists generally want to know about several things: the benefit to consumers (usually saved time or money); the barriers to entry; the distribution channel for your offering; and the follow-on technical support required. Of course, they also want to understand the overall market opportunity presented by your technology, as discussed in the financial considerations above.

Benefits: Whether a technology is useful is not a subjective question. Venture capitalists want to see objective criteria describing how your technology will directly benefit consumers. You must explain exactly how your technology will translate into cost or time savings for specifically identified customer types. Novelty doesn't equate to utility. Venture capitalists want your technology to serve a clear business purpose.

Barriers to Entry: If there are no barriers to prevent others from copying your technology, it will be difficult for your company to survive, since better funded, faster moving companies are always searching for opportunities to steal others' thunder. As a result, venture capitalists rarely fund companies that don't have some major competitive edge. Be sure you have one and are capable of being a market leader.

Distribution: A clear distribution channel for your product or service is mandatory for most venture capitalists. There are many great technologies that never get off the shelf and into the market. A straightforward, inexpensive path to getting to the ultimate consumer is imperative to give any credibility to your revenue projections. As mentioned

previously, the distribution and marketing strategy must be cost-efficient and tied to the goal of becoming profitable. Very expensive mass-marketing campaigns may get your product or service sold, but will wreck your bottom line. Also, details are particularly important here, as channel distribution plans often have hidden costs associated with minimum inventory requirements and product returns.

Customer Support: Venture capitalists want to know whether your technology offering will require customer support. In some cases, this may eat into future earnings of your company, without any coincidental offset through new revenues. Plus, it may impact the relative desirability of your product if it is not easy to use and needs constant support. On the other hand, ongoing customer support may mean a renewable income stream into the company, which clearly can be desirable.

Contacting Venture Capitalists

If, based on the factors outlined above, you believe that you will pass muster with a venture capitalist (not many do), then consider how to best approach a venture capitalist to get what you want. To begin with, invest in a good business plan. You should view the business plan as the inanimate ambassador for your company. As the point of contact in new territory, if it doesn't provoke smiles, you won't get funded. As a corollary to a good business plan, prepare an equally impressive visual presentation (e.g., through PowerPoint) for when you have an opportunity to formally pitch a venture capitalist.

The key to developing a good business plan and visual presentation is to answer the questions that the venture capitalists care about. If you include solid, concise coverage of the areas outlined above, you should be well on your way. There are many useful articles on how to prepare a business plan in accordance with accepted industry formats. These should be used to your advantage.

Most venture capital firms receive thousands of business plans each year. One way to make sure that your business plan receives special attention is to find the right person to deliver it. An accountant or attorney that works closely with a particular venture firm is often a good choice. Better still is an executive of a company that was funded by the target venture capital firm. A referral from another venture capital firm can be terrific, but be prepared for questions why that venture capital firm is recommending your company if it hasn't invested anything. The point is that a positive introduction of your business plan to a venture capitalist can make the difference between a cursory review and a detailed review, which in turn can make the difference between no cash and cash.

Once your business plan has been submitted to a venture capitalist, be sure to follow-up. Many perfectly good plans get forgotten or set aside simply because of the volume of submissions that venture capitalists get. Phone calls or emails to check on the status of your plan periodically can make a real difference. Don't leave your chances to fate--be proactive. But, be prepared to answer tough questions the minute you get a venture capitalist's attention.

Outside of submitting your business plan, another great way to get a venture capitalist to consider your company is simply to meet them at technology networking events. Venture fairs and similar events are held regularly in technology hot spots and should be attended when possible. Go to these events prepared with a forty-second speech summarizing all the key points about your business. Rehearse it well before you go and have ready answers to all the questions that you know the venture capitalist would ask if they read your business plan. Venture capitalists are always willing to hear about new opportunities, so long as the presenter is prepared. A well presented pitch often will be followed by a request for more information from the venture capitalist. That will get the ball rolling. And even if you don't get a chance to speak to a venture capitalist personally, you likely will hear the questions they ask others and can prepare yourself better for the next time.

Evaluating Venture Capitalists

Identifying the venture capitalists that are best suited for investing in your business, both in terms of their receptiveness to your business model and the value they bring to the table, can be a challenge. This requires a good bit of research and investigation. In particular, check to see what types of companies venture capitalists already have invested in, as opposed to what they say they will consider. This should provide some clues about their technology preferences and their expertise. Also, look at the biographies of their management to see where the venture capitalists have come from and with what types of industries they are most familiar. This process should help you narrow the universe of potential venture capitalists and allow you to be more focused in your fundraising efforts.

Assuming that there are at least several venture capitalists that appear to be well suited for your type of business opportunity, you should direct your energy toward those that will be of most value to you. Some criteria that will help you evaluate venture capitalists are their: (1) understanding of your business model; (2) long-term staying power; (3) contacts in your industry and in financial markets; (4) track record of success; (5) accessibility; and (6) long-term vision. Of course, the terms of a proposed investment will be very important, as will your ability to work with the venture capitalists on a personal level.

Additionally, be sure that you approach several venture capitalists at once, as this will save you time. Undoubtedly, some of the venture capitalists that you believe are well-suited for your business opportunity will fail to bite. Be sure you still have a few lines in the water to maximize your chances of landing your financing in a reasonable time frame. Also, keep in mind that no deal is done until the money has been wired into your account.

As a final note, throughout the process of raising venture capital, it is important to be open-minded. If your business model hasn't evolved during the process, you weren't listening hard enough. At the same time, be confident about the business opportunity you are presenting--it tends to be infectious.

ACCOUNTING POLICIES AND PROCEDURES FOR EARLY STAGE COMPANIES



Accounting Policies and Procedures for Early Stage Companies

By PricewaterhouseCoopers*

Introduction

This article is designed to address the needs of early stage companies with relatively simple accounting systems and transactions. It provides basic accounting procedures and controls that should be implemented in order to lay a foundation for a system of internal accounting controls.

As a company grows it will need expanded internal controls that transcend the scope of this document. Management must, therefore, be continuously aware of the growing control needs of the company and update the control environment as necessary.

General Ledger

The General Ledger (G/L) accumulates all accounting activity for an accounting period. The importance of the G/L system becomes apparent in light of a twofold objective that:

1. All transactions are properly accumulated, classified, summarized and recorded in the accounts; and
2. Financial transactions and reports accurately reflect the details of all operations.

As evidenced by the objective, the activities of a G/L system are varied, ranging from the preparation of journal entries (JEs) to the production of the final financial statements. The basic flow of events for a G/L system is simple, revolving mainly around the journal entry. Initially, JEs are prepared by summarizing the period's activity. JEs are then posted to the G/L. Reports are generated from the G/L, reviewed for accuracy and any variances are explained. Finally, financial statements are produced from the final general ledger.

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Because of the impact of the G/L system, the following key controls are imperative:

- ◆ Approval of all JEs by a designated officer before posting.
- ◆ Reconciliation of the various sub-ledgers (such as accounts receivable, fixed assets, accounts payable, etc.) to the G/L on a timely basis and investigation and correction of any discrepancies.
- ◆ Review of month-end financial statements by officers and managers, including prompt explanation of any variances or unusual activities.

As stated above, summarization of the month's activities is done via the journal entry. The different accounting activities which give rise to journal entries are as follows:

1. Cash activities

* PricewaterhouseCoopers (www.pwcglobal.com) is the world's largest professional services organization. Drawing on the knowledge and skills of more than 150,000 people in 150 countries, we help our clients solve complex business and accounting problems and measurably enhance their ability to build value, manage risk and improve performance in the technology world.

- ◆ Cash receipts - summarized by totaling the cash receipts journal (See **Cash** section).
 - ◆ Cash disbursements - summarized through a recap of the cash disbursements log (See **Cash** section). Note that automatic deductions from the bank account for insurance, payroll, etc. should be individually recorded upon notification.
2. Operating activities
- ◆ Accounts payable - summarized via the accounts payable and cash disbursements subsidiary ledgers (See **Cash & Purchasing Cycle** sections).
 - ◆ Accounts Receivable - summarized through a recap of the sales journal and the cash receipts journal (See **Cash & Revenue Cycle** sections).
 - ◆ Payroll - summarized through payroll reports generated by the outside payroll service (See **Payroll** section).
 - ◆ Depreciation/Amortization - summarized through the fixed asset log (See **Fixed Assets** section).
 - ◆ Amortization of prepaid expenses and other assets (see **Other** section) should be done by maintaining a supporting schedule for each pre-paid item. This schedule should include:
 1. The life of each item
 2. The monthly amortization

Prepare the JE by summarizing all monthly amortization. A typical JE to amortize the current asset pre-paid insurance follows:

Debit	Insurance expense	xx	
	Credit	Prepaid insurance	xx

The above entry retires (expenses) the portion of the asset which was “used up” in the period on which you are reporting.

- ◆ Any additional JEs must be backed up by supporting documents.
- After posting the approved JEs to the G/L certain reports should be produced. It is important that printed reports and supporting documents necessary to provide an “audit trail” are retained, as these will be useful in researching problems and supporting an examination by independent accountants. The following reports are usually generated.
- ◆ Trial Balance - Lists all G/L accounts with ending balances.
 - ◆ Financial Statements - Balance Sheet & Income Statement

Financial statements should be distributed to all officers and managers who have control over costs and have the ability to make financial decisions. The statements should be reviewed and discussed monthly and unusual items identified and investigated.

Chart of Accounts

The chart of accounts is the foundation of the accounting system. It lists all of the individual accounts (assets, liabilities, stockholders' equity, revenue and expense) of the company. Its length depends on the requirements of management and the nature of the company's operations.

Cash

Cash Receipts

Adequate control over cash receipts is essential. An individual outside the accounting function, such as a receptionist, should be designated to open the mail every day. Checks received should immediately be restrictively endorsed and entered on a daily cash receipts log (prepared in duplicate).

Checks remitted without stubs or backup information should be photocopied and attached to the accounting copy of the cash receipts log.

A copy of the daily cash receipts log and the check stubs and/or backup information should be sent to accounting. One individual in accounting should be responsible for recording the cash receipt by allocating the funds to the appropriate customer account and creating the cash receipts entry. This is most effectively done through the use of a cash receipts journal with specialized columns for routine transactions.

The second copy of the daily cash receipts log and the endorsed checks should be forwarded to a responsible individual in the accounting department who is not responsible for processing cash receipts. The person should complete the bank deposit slip and verify the completeness and accuracy of the deposit by agreeing the total to be deposited to the total per the daily cash receipts log. A duplicate deposit slip, stamped received by the bank, should be returned and attached to the accounting copy of the daily cash receipts log.

Deposits should be made on a daily basis. Cash (except petty cash) should not be kept on the premises overnight.

As your product or service begins to generate revenues you should consider the possibility of a lock box arrangement with your bank. Adopting a lock box arrangement will eliminate the administrative task of recording receipts, reduce the potential misapplication of cash by employees, and afford better cash management.

Cash Disbursements

The control of cash disbursements should be of supreme concern to you. Cash is a liquid asset that can be easily misappropriated. Thus, management control over this area is especially critical.

Basic controls of cash include:

1. Management should approve authorized check signers and record this information with the bank. Management should also set dollar limits above which two signatures are required. For example:
 - ♦ checks written for < \$1,000 might require one authorized signer
 - ♦ checks written for > \$1,000 might require two authorized signers
2. No checks should be prepared without proper approval. All cash disbursements should be based on supporting documentation such as an appropriate invoice, completed expense report, etc.
3. All checks should be pre-numbered and all check numbers should be accounted for. Unused checks should be stored in a locked area and physical access limited to authorized personnel only.
4. The cash disbursements clerk should not reconcile the bank accounts or be an authorized signer on the bank account.
5. Voided checks should be retained to provide a trail when reconciling the bank account. (See section “C” below for Bank Reconciliation Procedures).

A three part check is suggested:

- ♦ original sent to the payee
- ♦ first copy attached to the invoice upon payment and filed by vendor
- ♦ second copy retained in a file in numerical order

Cash is generally disbursed for the major categories of accounts payable, expense reports, payroll and petty cash. The cash disbursements procedures are presented by category:

Accounts Payable:

- a. Invoices should be approved for payment in writing after review by an authorized individual, who indicates approval by initialing the invoice. A total of the invoices to be paid should be calculated for later reference. This total is called a batch total.
- b. Checks may be generated manually or through a computer system. Each check “run” should result in a check register/cash disbursements journal which lists:
 - ♦ Run/disbursement date
 - ♦ Check number
 - ♦ Payee
 - ♦ Invoices check is paying
 - ♦ Purchase order #
 - ♦ Amount

The total from the check register should be compared to the batch total calculated in 1 above. Differences should be reconciled immediately.

- c. Supporting documents, referred to as a “voucher package”, are attached to the check for signing. The voucher package usually contains a:
 - ♦ purchase order
 - ♦ packing list
 - ♦ receiving report
 - ♦ invoice(s)
- d. The check signer(s) signs the check and initials the “approved by” section of the voucher stamp. The check signer should review the voucher package for completeness and accuracy before signing each check.
- e. Signed checks should be mailed immediately by someone not involved in steps a-d above. Do not return the checks to the check preparer. Check copies and voucher packages should be filed in the vendor paid file.

Note:

 - ♦ Checks should be mailed immediately.
 - ♦ Checks should not be prepared if they are not going to be remitted immediately.

Expense Reports:

- a. Expense reports should be completed on a timely basis.
- b. Receipts for out-of-pocket expenses should be attached to the expense report (if receipts are not retained tax deductions may be denied by the IRS).
- c. The dates, times and business relationship should be stated.
- d. The employee should sign and date the expense report prior to its submission to accounting.
- e. Meal and entertainment costs must be separated from travel costs. The tax law allows only a portion of meals and entertainment expenses to be deducted.

The approved expense report should be treated as an approved invoice. The voucher stamp should be affixed and the accounts payable recording process should be commenced (steps a-e of accounts payable).

Payroll: The use of an outside payroll service is recommended for early stage companies. See the **Payroll** section for discussion of preparation of data for the payroll service and the services provided by a payroll service. In connection with the payroll service, it is beneficial to maintain a separate bank account for payroll. A zero balance account should also be considered.

Similar to the accounts payable voucher package, payroll has its own package consisting of an employee time card or time sheet and the payroll register. Issuance of the employees’ checks and preparation of a check register correspond directly to the

procedures in Accounts Payable. An additional requirement is the computation of deductions and withholdings. Regular payroll tax returns and deposits must be made to federal and state revenue authorities.

Occasionally, it will be necessary to write a manual payroll check. A special register for such checks should be maintained by the payroll clerk, and the entry to the payroll register should be initialed by the person authorized to sign the payroll check when the check is signed. Any hand written checks should be communicated to the payroll service during the next regular data input.

Petty Cash: Petty cash is a revolving fund maintained at a constant (imprest) amount to cover the local emergency needs and small cash expenditures such as postage, minor office supplies, travel advances, etc.

At all times the general ledger petty cash account balance should be the amount of cash that was originally advanced to the custodian of the petty cash account. Only when the amount originally advanced is increased or decreased should the general ledger balance change.

The following procedures are helpful in establishing and maintaining the petty cash account:

- a. To establish the petty cash account, draw up a check to the name of the custodian for an amount sufficient to cover small expenditures for a designated period of time.
- b. Approved petty cash vouchers should be presented to the petty cash custodian before cash is removed from the fund. The vouchers should indicate the amount and purpose of the expenditures and be adequately documented.
- c. Replenish the petty cash when it is nearly depleted. Total the petty cash vouchers to determine the replenishment amount and process the petty cash reimbursement as an invoice.
- d. The cash on hand plus the non-reimbursed petty cash vouchers should at all times total the constant (imprest) amount per the general ledger.

Bank Reconciliation

Purpose: To reconcile the differences between the general ledger balance (books) and the bank statement balance.

The bank reconciliation process is an important element in the internal control over cash, and is particularly critical where adequate segregation of duties is not feasible. It is essential that the reconciliation be pre-pared by someone other than the person who actually processes the cash receipts and disbursements. The reconciliation must be approved by management or a designated official. The bank reconciliation process will be expedited if a separate general ledger account is maintained for each bank account.

The procedures involved in the preparation of a monthly reconciliation are as follows:

1. Establish the accuracy of the bank statement.
 - a. Ensure that the beginning balance in the bank statement agrees to the ending balance of the prior month's bank statement.
 - b. Agree each deposit in the bank statement to the duplicate deposit slip receipt from the bank.
 - c. Agree each paid check returned by the bank to the bank statement listing of checks.
 - d. Agree debit and credit memos per the bank statement to the memos mailed by the bank.
2. Determine the reconciling items between book and bank balances.
 - a. Outstanding Checks - Checks recorded as cash disbursements per the books but not presented to and cashed by the bank as of the bank statement date.
 1. Arrange the paid checks returned from the bank in numerical order.
 2. Agree each paid check with the related cash disbursements entry and the list of outstanding checks for the previous month (if applicable). Check off each entry in the cash disbursements journal to indicate that the check has been cashed by the proper payee for the correct amount and returned by the bank.
 3. The outstanding checks represent the total of the unmarked disbursements in step (2) above.
 - b. Deposits in Transit - Deposits recorded as cash receipts per the books but not presented to the bank and available for use as of the statement date.
 1. Agree each deposit entry per the bank statement with the deposits recorded in the cash receipts journal. Check off the deposits per the cash receipts log which have been recorded as deposits by the bank.
 2. Any unchecked items in the cash receipts log represent deposits in transit.
 - c. Other Reconciling Items
 1. Examine the bank statement for additional debit or credit items not recorded in the company's books such as:
 - ♦ Check returned for insufficient funds –These items should be deducted from the cash book balance. In addition, it is

important to remember to re-establish the amount as a receivable.

- ◆ Collection charges - These amounts should be deducted from the company's books and recorded as an expense.
 - ◆ Bank charges - Again, these amounts should be deducted from the company's books and recorded as an expense.
 - ◆ Fund transfers - Record amount in company's books and ascertain that amount is properly recorded in other accounts. For example, if it is an interbank transfer, the offsetting bank account must also show the transfer or, if it is a transfer from a customer, accounts receivable must be reduced.
2. Examine the company's books for any open/unmarked items, e.g. checks recorded but still in the company's custody. Held checks should be recorded as payables until the checks are released.

Investments

Cash management is very important to a young company. Investment policies are too complex to fully discuss here, but controls for managing investments should include the following:

1. The Board of Directors should formally define authority limits in terms of the types and amounts of investments that may be purchased, and the persons authorized to carry out investment transactions.
2. Cash flow forecasting must be sufficient to determine how much money can be placed in long-term versus short-term investments.
3. Procedures should be in place to evaluate short-term investments, specifying methods to be used to (a) calculate yield or market value appreciation and (b) compare the result obtained with realistic, conservative investment goals.
4. Procedures should be in place to evaluate long-term investments, describing the criteria used for comparing investment performance with investment objectives.
5. Procedures for periodic top executive review and approval of investment activity should be established and consistently followed.
6. Consideration should be given to having all physical instruments held in safekeeping accounts at banks for security reasons.
7. Regular reporting of investment activity to top management should be required.

The Purchasing Cycle

The purchasing cycle involves ordering, receiving and paying for goods and services required by the organization. The cycle consists of the following steps:

- ◆ Identification of a need
 - ◆ Placement of an order
 - ◆ Receipt of the goods or services
 - ◆ Approval for payment/establishment of payable
 - ◆ Disbursement of cash
 - ◆ Recording of the transactions involved
1. The need for the acquisition of goods or services may arise in several areas and may be a routine one, such as inventory replenishing, or a one-of-a-kind item or service. Inventories should be routinely reviewed to identify items whose on hand balance has fallen below a predetermined reorder point. For more significant purchases, the individuals responsible for ordering merchandise should be encouraged to get several bids to ensure that the company is purchasing goods at the lowest possible cost. While this may appear to be a very time intensive effort, especially during the development stages of the business, significant price variations in the marketplace will make it worthwhile to shop around.
 2. Typically one individual (purchasing department) should be the focal point through which all orders are channeled. The originating department issues a purchase requisition, and the purchasing department prepares a purchase order (P.O.) that is sent to the particular vendor. P.O.'s should contain the following components:
 - ◆ Name of your company
 - ◆ Name and address of vendor or supplier
 - ◆ Vendor number (established by your organization and maintained on a Vendor Master File)
 - ◆ Purchase order number
 - ◆ Requisition number
 - ◆ Authorization
 - ◆ Date of issue
 - ◆ Required delivery schedule
 - ◆ Terms and conditions
 - ◆ Shipping instructions
 - ◆ Insurance required
 - ◆ FOB point
 - ◆ Responsibility for damage
 - ◆ Billing instructions
- P.O.'s should be pre-numbered for control purposes. P.O.'s are normally prepared in multiple form with the original routed to the vendor, and copies to the originating department, the receiving department, the warehouse or stock room

and finally the accounting department. One copy is retained in the purchasing department.

3. When goods are received from a vendor, the receiving department checks them to ensure that their identity, quantity and quality conform to the purchase order. A receiving report is prepared in duplicate detailing this information. The receiving report not only provides a basis for subsequent payment of the vendor invoice, but also serves notice of the correct timing to record the purchase transaction. One copy of the receiving report should be maintained by the receiving department in a receiving log and the second copy should be forwarded to accounting. Whereas goods are received at a certain time, services may be rendered over an extended period, making a receiving report inapplicable. Instead, a formal statement that the services have been duly provided is necessary.
4. Payment terms between your company and the vendor depend upon whether credit arrangements have been established. If no credit arrangements are in place, the vendor may demand cash on delivery or advance payment. When credit arrangements are in effect, the goods are normally delivered in anticipation of payment at some later date. Approval for payment is normally a formality, provided the goods or services have been delivered as requested. The voucher is a key element in initiating payment to the vendor. It is basically a summary of the items contained in the voucher package. The package consists of a purchase order, packing list, receiving report and supporting invoice(s). Upon approval by appropriate authority, the disbursement process begins.

Disbursement may be made immediately or delayed. The payment schedule adopted depends on:

- a. the availability of any favorable discounts for prompt payments and
- b. the organization's current cash position.

A cash requirements forecast may be prepared at regular intervals showing the amount of cash needed to pay certain categories of vouchers. Also, a schedule of aged accounts payable (analogous to the accounts receivable aging) may be prepared.

5. If the purchase is on credit, recording the purchase requires the establishment of a payable. This is a twofold process. Consider the purchase of supplies on account from XYZ Supply Co. in the amount of \$5,000. The accounting department matches its copy of the approved purchase order with its copy of the receiving report, which triggers the recording of the transaction in the general ledger as follows:

Debit Supplies	5,000	
Credit Accounts Payable		5,000

In addition to recording the \$5,000 in the accounts payable control account, the \$5,000 must be entered in the accounts payable subsidiary ledger, which is a file detailing what amounts are owed to each vendor individually.

The establishment of a payable relates not only to the purchase of inventory, supplies, fixed assets, and intangible assets, but to the receipt of services as well. There is one area of concern that can not be overlooked when accounting for payables, namely the area of accruals. For example, when the time period related to an expense (receipt of service) spans two accounting periods, the portion related to each period must be duly recorded in each, even though there will be only one disbursement. A simple example is a utility expense payable on the 15th of every month with \$200 payments. If the company has a year end of 12/31/X1, this means that the January 19X2 utility payment (disbursement) will be applicable to services received in both accounting periods. If the December portion (1/2 payment) is not accrued at year end 19X1, the entire \$200 expense will be charged to 19X2 when the disbursement is made, when only \$100 should be. In order to correct this problem, the portion of the expense related to the current year is accrued as a payable on December 31, 19X1.

Dec. 31 Debit Utilities Expense	100	
Credit Utilities Payable		100

On January 15, 19X2, when the payment is made, the following transaction is recorded:

Jan. 15 Debit Utilities Payable	100	
Debit Utilities Expense	100	
Credit Cash		200

Note that this treatment results in 1/2 of the \$200 utilities expense being recorded in the period ended December 31, 19X1, and 1/2 being recorded as an expense in 19X2. This is necessary to match the expense actually incurred with the proper accounting period regardless of when the disbursement is made to pay the expense.

The Revenue Cycle

Revenue should be recognized when the earnings process is complete (or virtually complete) and an exchange has taken place. There are some exceptions (percentage of completion, installment sales and franchise revenue) that are too technical to expound on here. If it appears that one of these methods may be more appropriate for the company, contact an accountant for assistance. Following are some examples of when revenue should be recognized:

- ♦ revenue from selling products is generally recognized at the date of sale (i.e. date of delivery to customers)
- ♦ revenue from services is recognized when services have been performed.

- ♦ revenue from disposing of assets other than products, is recognized at the date of sale.

The revenue cycle incorporates the receipt and processing of sales orders, the shipment of goods or providing services to customers and the related billing and collection activities. The revenue cycle typically consists of the following activities:

- ♦ Receipt of an order
- ♦ Credit screening and approval
- ♦ Shipment of goods or provision of services
- ♦ Customer billing and servicing of accounts receivable
- ♦ Collection of cash
- ♦ Recording of the accounting transactions
- ♦ Sales analysis

Other related activities include the setting of sales prices, costing of sales, provision for bad debts, write-off of uncollectible accounts and provision for warranty expenses.

Receipt of an order

The sales order may originate from a variety of sources such as telephone, fax or mail. Where custom goods or services are involved, a negotiated contract may accompany the sales order. Regardless of the manner in which the order is placed, the company must implement a specific policy defining what will qualify as a request for shipment or delivery of service. Numerous complications can arise when a specific policy is not set, for example; if salespersons receive a commission based on sales orders booked, some bookings may be recorded which are not actual sales, but rather a request to “try out” the product or service on a trial run. If an organization does not require a hard copy of the sales order/purchase order request received from the customer, the chance of invalid sales occurring increases.

Credit Screening

In the case of regular customers, credit information should be stored in the customer master file or credit file. The credit information can be expressed as either a credit rating or a credit limit. A credit rating is a rating of customers by credit worthiness. A credit limit is a dollar limit up to which credit sales are automatically authorized. A credit rating or limit provides a means for routine screening by sales persons acting under a general authorization. The establishment of credit arrangements may precede the placement of the first order placed by the prospective customer, or it may be initiated some time later after a number of cash sales have been completed. The credit arrangements should be reviewed periodically, and revised according to improved or deteriorated relationship that has developed. Obviously, the level of the credit limit or rating that is set depends upon the financial stability and reputation of the customer, the customer’s previous payment record and the eagerness of your company to do business with the client. Credit references from banks or from other suppliers doing business with the particular customer are useful sources of information in determining a credit limit.

Shipment of Goods or Provision of Services

Frequently, an order for goods extends to several different items. In the case of an extensive inventory of differing items, a picking ticket is often prepared to facilitate the retrieval of the items from inventory. The picking ticket identifies the items and quantities required and gives the warehouse location. In situations where inventories are smaller, a copy of the sales order may be deemed sufficient in requisitioning the goods. Some form of paperwork must accompany the goods in transit. It may be in the form of a copy of the invoice (with price data omitted), or it may be a separate shipping document such as a packing slip. Insurance must be arranged for the shipment, and if a common carrier is involved, then a bill of lading will be required. A bill of lading forms the contract between the shipper (seller) and the common carrier. A shipping log should be kept by the shipping department which lists all shipments, the date of the shipment, and the corresponding shipping document number.

Billing and Collection

Preparation of an invoice should take place simultaneously with the shipment of goods. A control such as a reconciliation of invoices to the shipping log should be implemented to ensure that all goods shipped are billed.

Where goods are supplied or services are to be rendered over a period, invoices for progress payments may be sent during the period with a final invoice at the end of the period. There are two principle types of accounts receivable systems: the balance forward type and the open invoice type. The former applies payments to the outstanding balance rather than against particular invoices; there is no attempt at matching individual payments and invoices. On the other hand, with the open invoice system, individual payments are matched to specific invoices. Typically, the open invoice system is preferred so that disputes over invoices can be highlighted and resolved in a more effective manner. If the customer is not satisfied with the goods that have been provided, part or all of them may be returned, or the customer may keep the goods and seek an allowance or adjustment of the invoice amount. Cancellation of an invoice or adjustment of the amount due is formalized through a credit memo, a copy of which is sent to the customer. If there is an ongoing relationship between the customer and the organization, the credit memo may serve to reduce the amount of future payments. Otherwise a voucher should be prepared and a refund check sent to the customer.

Accounting Transactions

The formal accounting transactions involved in the revenue cycle include the sale and establishment of the receivable, the relief of inventory and recognition of the cost of goods sold, the adjustment of the invoice amount to reflect a return or allowance, the recognition of sales discounts or sales tax and the final collection of cash. The receipt of the sales order is not the occasion for a formal transaction; rather, a form transaction occurs when the earnings process is complete, usually upon shipment of the goods. The point of sales order, however, is of importance from an internal management perspective. The following series of entries represents the recording of a credit sales transaction.

- 1) The following is an example of a sale of inventory on credit for \$1,000 and a 5% sales tax, to a customer with credit terms of 2% discount if paid within 10 days, if not, the entire balance is due in 30 days:

Debit Accounts Receivable	1,050	
Credit Sales		1,000
Credit Accrued Sales Tax Payable		50

Explanation: The sale of goods on credit for \$1,000 with 5% Sales Tax Terms 2/10 net 30

An entry must also be made in the accounts receivable subsidiary ledger, which is a file detailing what amounts are due from specific customers, updating that particular customer's account.

- 2) When goods are sold, inventory on hand is decreased; thus a second transaction in addition to #1 must be recorded. The purpose of this transaction is to relieve inventory for the goods that were sold, and transfer the cost to Cost of Goods Sold. We will assume that the \$1,000 sale in #1 relates to inventory which has a book value of \$800. The following transaction is required:

Debit Cost of Goods Sold	800	
Credit Inventory		800

Explanation: To relieve inventory of goods sold on xx/xx/xx and charge cost to Cost of Goods Sold.

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- 3) If the credit sale is paid within the discount period, the accounting for the receipt of payment requires the use of an additional account. Its purpose is to accumulate all discounts taken on credit sales into one account. Let's assume that the \$1,000 sale of goods in transaction #1 above is paid by the customer within the discount period, the customer having subtracted the 2% from its remittance. The following transaction would be necessary:

Debit Cash	1,030	
Credit Sales Discounts		20
Credit Accounts Receivable		1,050

Explanation: To record the payment of invoice #1234 net of 2% discount

Note that the 2% discount is applicable only to the \$1,000 of inventory, not the \$50 of Sales Tax and that the accounts receivable of \$1,050 established in transaction #1 has been eliminated. The receivable established in the accounts receivable subsidiary ledger (customer file) must be removed from the customer's account as well.

- 4) If the sale of goods is followed by a sales return, a transaction involving the **sales returns** account is recorded. This account is treated as a reduction from sales on the income statement in the same manner that the sales discounts account is.

We'll assume that the \$1,000 sale in transaction #1 is followed by a \$500 return instead of the payment and discount of transaction #3. The following transactions are necessary.

Debit Sales Returns	500	
Debit Accrued Sales Tax Payable	25	
Credit Accounts Receivable		525

Explanation: To record the return of merchandise sold on invoice #1234, including sales tax

The customer's individual account in the receivable subsidiary ledger must be credited for the returned merchandise as well.

Further, note that the above transaction only addresses the sale. Assuming that the goods are not damaged and are fit for resale, they must be added back to inventory. This requires an additional entry as follows:

Debit Inventory	400	
Credit Cost of Goods Sold		400

Explanation: To add back to inventory returned goods sold on invoice #1234

Sales on any basis other than cash make subsequent failure to collect the account a possibility. An uncollectible account receivable is a loss of revenue that requires a decrease in the asset "accounts receivable" and a related expense to recognize the loss one of two methods of recognizing the uncollectible account receivable are typically used: the direct write-off method or the allowance method.

Direct write-off: No entry is made until a specific account has been determined to be uncollectible. The expense is then reported as follows:

Debit Bad Debt Expense	xxx	
Credit Accounts Receivable		xxx

Allowance: An estimate is made of the uncollectible accounts for all sales made on account for the current period. An account, the allowance for doubtful accounts, decreases the accounts receivable balance. The following entry details the allowance method.

Debit Bad Debt Expense	xxx	
Credit Allowance for Doubtful Accounts		xxx

Explanation: To establish allowance for doubtful accounts.

Debit Allowance for Doubtful Accounts	xxx	
Credit Accounts Receivable		xxx

Explanation: To directly write off individual accounts that are deemed uncollectible.

The allowance method affords a more proper matching of expenses and revenues and achieves a more appropriate carrying value for accounts receivable at the end of period. In addition to these accounting transactions, the payment of sales commissions or bonuses represents a further accounting transaction.

Sales Analysis

Many organizations generate a variety of sales analyses that are derived from the sales journal. Sales history is accumulated for analysis by management to aid planning and control. Sales recorded over some period of time may be analyzed by customer type, by region or territory, by product type, by dollar amount and so forth. The information relevant to your company should be derived and isolated for analysis.

Accounts Receivable Aging

A critical report necessary for control over accounts receivable is the aging report. In order to maintain favorable cash flow, it is recommended that each receivable's status be monitored. The report is prepared from the open invoice file either by manual or automated access, depending on the system you choose. The open invoice file is a file of invoices usually maintained chronologically and sequentially for which the customer has not yet remitted payment. The aging report contains the individual invoices coming to a total balance due from each customer along with an age category (30, 60, 90, >120 days). The aging report should regularly be analyzed and late payers identified and addressed immediately. Late payers may be indicative of liquidity problems on the part of the customer, quality problems with respect to merchandise shipped, etc. Timely identification of potential problems and remedial action is the key to successful accounts receivable management.

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Inventory

Inventory represents goods held for sale in the ordinary course of business. Identification and valuation of inventory are critical because inventory can have a material impact on both the balance sheet and the income statement.

The inventory on-hand at the end of an accounting period is reported as a current asset on the balance sheet as the intent is to sell it or use it to produce goods that will be sold within one year, or one operating cycle, whichever is longer.

Controls over inventory are critical, however, the subject is too complex to cover in detail in this manual. Listed below are the items of major concern that should be considered when establishing inventory controls.

Physical Safeguards Over Inventories

Proper safeguards over inventories should be in place to avoid shrinkage due to loss, theft, damage etc. These may include locked storage areas for high value items, limited access to secured areas, and adequate security at warehouse locations.

Conduct of Periodic Physical Inventories and Appropriate Adjustment of Books

The inventory on-hand at the end of an accounting period is determined by a physical count. If a periodic inventory system is used, a physical inventory count is essential because, as the name implies, the amount of inventory on-hand is determined only periodically and the cost of goods sold is a residual amount that is dependent upon the ending inventory.

When a perpetual inventory system is used, there is a continuous record of the inventory balance. Purchases of inventory are recorded as a debit to the inventory balance and sales of inventory are recorded by debiting cost of goods sold and crediting the inventory balance for the cost of the inventory. When a perpetual inventory system is used, physical counts of inventory are performed to verify the amount of inventory as reported by the perpetual inventory records.

The physical inventory count may result in a balance different from that reported by the perpetual records. This may be the result of bookkeeping errors, counting errors or inventory shrinkage (i.e. theft, waste, loss of inventory items). If a difference results, the balance of inventory should be adjusted to agree with the physical count by making a “book-to-physical adjustment” to the accounting records. For reporting purposes, any overage or shortage would be recorded as an adjustment to cost of goods sold.

Management Authorization of Major Inventory Purchases

The appropriate level of management should be responsible for authorizing major inventory purchases. The level subject to authorization should be determined based on the individual company’s needs and level of purchases on an on-going basis. Purchasing levels should be appropriate for the expected volume of sales.

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Obtaining Accurate Production Cost Information

The cost of inventory includes all expenditures necessary to get the inventory into condition and location for sale. Inventory cost therefore includes not only the purchase price of the goods, but also expenditures such as freight-in, storage, inventory related insurance and taxes and materials and labor used to manufacture such inventory.

If goods are manufactured, inventory is typically classified into three major categories: raw materials, work-in-process (WIP) and finished goods. The cost of raw materials inventory is the actual cost of the products purchased, adjusted for any freight-in, purchase discounts, etc. Direct labor cost includes the salaries and wages of those workers directly involved with the manufacturing process. Manufacturing overhead includes all manufacturing costs other than the cost of raw materials and direct labor. Examples of such costs include the cost of indirect labor, such as the salary of the operations manager, indirect materials and a properly allocated portion of general overhead expenses such as utilities, depreciation, taxes and insurance.

There are several methods for assigning costs to ending inventory and cost of goods sold. The most common procedures used include average cost, first-in-first-out (FIFO) and last-in-first-out (LIFO).

Valuation of Inventory at Lower of Cost or Market and Write-offs of Obsolete Items

In certain instances, departure from the historical costs basis of valuing inventory may be appropriate. Generally accepted accounting principles require such a departure if the revenue-producing ability through the sale of inventory falls below its original cost. When physical deterioration, obsolescence, a change in the price level, or any other event causes the value of inventory to fall below its cost, a loss should be recognized in the current period income statement, and the value of inventory reduced on the balance sheet for the difference. In these instances, inventory is valued at the lower of cost or market rather than at historical cost

Accurate Shipping/Receiving Logs

Maintaining accurate shipping logs is important as most merchandising and manufacturing companies recognize revenue at the point of sale. At this time, the earnings process is complete or virtually complete because the merchandise has been transferred to the buyer. In addition, maintaining accurate records is important should there be a customer dispute regarding receipt of the merchandise.

Maintaining accurate receiving logs is important as companies typically record inventory purchases as goods are received. However, purchases of inventory should be recorded by the buyer when legal title passes.

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Fixed Assets

A Fixed Asset is generally any asset purchased for use in the day to day operation of business and from which an economic benefit will be derived over a period greater than one year. This category of assets includes items of property and equipment such as buildings, office furniture, or delivery trucks, and excludes such assets acquired for resale (inventory), investment, maintenance (e.g. supplies), or general and administrative expenses. At the time a fixed asset is acquired, its cost is capitalized and subsequently depreciated over the asset's estimated economic life (with the exception of land which is not subject to depreciation).

Three economic events occur in the fixed asset cycle; fixed assets are:

1. acquired, constructed, created or discovered
2. used or consumed and lose their value over time
3. disposed of

Assets should be recorded at their acquisition cost, including freight, tax and installation charges. Assets capitalized each month should be listed separately in a fixed asset log that is reconciled to the general ledger on a monthly basis. Suggested categories include:

- ♦ Land

- ◆ Buildings
- ◆ Autos/Trucks
- ◆ Furniture & Fixtures
- ◆ Manufacturing Equipment
- ◆ R & D Equipment
- ◆ Leased Equipment under Capital Lease
- ◆ Leasehold Improvements

As capital assets are added to the fixed asset log each month, a fixed asset number should be assigned and a corresponding pre-numbered asset sticker should be placed on the actual asset. Asset stickers can be purchased at most stationary stores. Such stickers facilitate control over the assets by allowing you to take periodic “physical inventories” of your company’s assets.

One problem area within accounting for fixed assets is determining when an expenditure related to the asset should be expensed (i.e. maintenance) or capitalized (added to the book value of the asset and depreciated). Generally, small dollar expenditures are expensed as incurred, while expenditures that increase the economic life, or improves the services derived from a fixed asset capitalized (added to the book value and depreciated).

Company policy should determine what types of expenditures or purchases are capitalizable, and what dollar amount the expenditures must be to require capitalization vs. expense treatment. Generally, a company establishes a dollar limit, such as \$250, when deciding which expenditures to capitalize and which to expense.

Depreciation

Certain conventions may be adopted in the company’s depreciation policies. For example, a full month of depreciation may be taken in the month of acquisition and none in the month of disposal.

When selecting a depreciation method, you should select the method that most aptly fits your specific situation. The most common depreciation methods for book purposes include straight line, double declining balance and sum of the year’s digits.

At month end, the depreciation expense on each fixed asset should be calculated in compliance with the adopted method, and the proper entry posted to the General Ledger. This means that a portion of the asset’s cost is expensed in each accounting period throughout its useful economic life. This is a system of cost allocation, not of asset valuation. Note that depreciation is not subtracted (credited) directly from (to) the fixed asset account, but is accumulated in a contra-account called Accumulated Depreciation. This account is netted against the fixed asset account for balance sheet presentation, and in the determination of any gain or loss on disposal of the fixed asset when it is sold. The accumulated depreciation account continues to increase in balance, to the extent of the cost of the asset, until the asset is fully depreciated or disposed of. The account balance is eliminated only when the asset is taken off the books. Generally a separate accumulated depreciation account is utilized for each fixed asset. The following example illustrates the

recording of monthly depreciation on a fixed asset (company truck) using the straight-line method of depreciation, an initial cost of \$10,000, and an estimated economic life of 3 years with no salvage value. The straight-line method is widely used due to its simplicity. The depreciation expense is calculated using the following simple formula:

$$\frac{\text{Cost Less Salvage Value}}{\text{Estimated Life of Asset}} = \text{Depreciation Charge}$$

Where salvage value is the estimated dollar amount expected to be received for the fully depreciated asset upon disposal.

Applying example information in the above formula will result in the calculation of the following depreciation charge and subsequent example entry.

$$\frac{\$10,000}{36 \text{ months (3 years)}} = \$278 \text{ depreciation per month}$$

Oct. 31 Debit Depreciation Expense 278
 Credit Accumulated Depreciation - Truck 278

Explanation: To record the October depreciation expense on a straight-line basis for the company truck

When adopting a depreciation policy for book purposes, keeping in mind that depreciation is a form of cost allocation, you should choose a method that is consistent with the economic benefit derived from the asset's use. If the benefits derived will be approximately equal throughout its life, straight-line depreciation is appropriate. If, on the other hand, the greater benefit will be derived early in the life of the asset, a method that is accelerated or results in a higher depreciation expense charge in earlier months/years may be preferable.

Leases

There are two basic types of leases from a financial statement standpoint, a capital lease or an operating lease.

Basically, the factors which determine the type of lease are:

1. The existence of a bargain purchase option at the end of the lease term
2. Transfer of title of the asset to the lessee at the end of the lease term
3. The length of the lease in comparison to the useful life of the asset
4. The present value of lease payments made by the lessee in comparison to the fair value of the asset.

The above factors must be evaluated for each lease entered into and the financial statement treatment determined. Essentially, a capital lease is one that transfers all of the benefits and risks incident to the ownership of property to the lessee. Assistance from an accountant is recommended when determining the proper treatment of leased assets.

The financial statement impact of classification for the leases is described below:

1. Capital lease - A capital lease is reflected on the lessee's balance sheet as both an asset and a corresponding liability. A capital lease generally produces a declining income statement charge over the term of the lease, represented by the sum of amortization of the capitalized asset, usually straight-line, and a declining interest expense element on the lease obligation balance. The effect is similar to that which would result if the lessee borrowed money and purchased the asset outright instead of leasing it.
2. Operating lease - An operating lease normally results in a level income statement charge over the term of the lease, reflecting the rent payments required by the lease agreement. An operating lease does not result in an asset or liability being reflected on the lessee's balance sheet.

Payroll

For companies in the early stages of development, the use of an outside payroll service is encouraged since payroll withholding computations and remittance requirements are cumbersome, often time consuming and subject to error. The following discussion of payroll assumes use of such a service.

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Time cards or time sheets should be filled out each pay period by every employee in the company. All time cards should be signed by the employee and approved by an authorized person separate from the payroll function.

Authorized time cards should be submitted to the payroll clerk prior to any payroll data being communicated to the payroll service. The payroll clerk should confirm the employee's department and verify the hours by re-extending hours worked.

The payroll service should provide numerous reports including:

1. A payroll register with departmental and grand totals
2. A payroll tax recap with departmental and grand totals
3. A recap of employees' year to date wages.

The payroll service should return the checks without signatures affixed. The employee name and net wages per each paycheck should be agreed to the payroll register and the number of hours worked agreed to the approved time card before the paychecks are signed. Individuals outside of the payroll and personnel functions should sign and distribute the paychecks.

The payroll service should deposit taxes and prepare and send payroll tax reports to the various agencies. The following taxes will be reported to these agencies:

1. Federal income tax
2. FICA tax - both employer and employee
3. Federal unemployment tax
4. State income tax
5. State unemployment tax

Note: Not all payroll services perform all of the functions mentioned above. Make sure that there is a clear understanding of what is expected from the service you choose. Unlike the computations involved in determining pay-roll expense, recording the related journal entries is a simple and straightforward process. There are several payroll related accounts, and care must be taken to post the proper amounts to each. To illustrate, here is the entry to record a hypothetical bi-monthly payroll expense of \$50,000 with related taxes withheld. For demonstration purposes, assume 7% state tax, 10% federal tax, and 7.15% FICA.

Debit Salaries Expense	50,000	
Credit Federal Income Taxes Payable		5,000
Credit State Income Taxes Payable		3,500
Credit FICA Taxes Payable		3,575
Credit Cash or Salaries Payable		37,925

Explanation: To record payroll and related taxes for the period ended 10/31/X1

In addition, the use of an imprest account, a separate account to which one check is deposited for the entire payroll and from which all payroll checks are drawn, is recommended. Such an account will facilitate greater control over payroll disbursements.

Personnel

When dealing with personnel matters, it is important to retain proper, complete information. This is necessary for such matters as providing assistance in the hiring of qualified personnel, providing employees with timely and useful reviews and evaluations, the issuance of timely and accurate paychecks, assuring the satisfaction of governmental regulations regarding employees, assurance that compensation and benefits packages are allowing the recruitment and retention of competent personnel, and to assure a safe, healthy, and productive work environment.

A personnel file should be maintained for each individual in the company. Each file should contain forms that authorize the hiring, payment, deduction of taxes and insurance benefits, discipline and termination of employees.

Personnel records should always be locked and access restricted to authorized personnel only. Persons responsible for the personnel files should not have the authority to approve time cards or time sheets.

Terminating employees should return any company property prior to receiving their last paycheck. Change passwords to computers or security systems as soon as possible after an employee terminates.

Employee Benefits

Equity-based Compensation

The typical start-up company is faced with the problem of structuring compensation packages that will attract high quality individuals despite the constraints of limited cash resources. It is possible to use equity to bridge the gap between what a top-notch individual expects to be paid and the company's cash constraints. Granting equity to employees gives the individuals an opportunity to share in the potential appreciation of the company's value and also provides incentives to contribute to that appreciation; that is, if the employees have a stake in the company, they should be motivated to work harder to maximize the value of their shares or options. Some companies grant options to everyone in the organization, with the number of options granted to each individual based upon his or her level in the organization. Equity granted to individuals generally is in the form of stock options or restricted stock, although some companies use more complicated SARs or phantom stock. Usually, a company reserves around 10% of its stock for use in stock option and restricted stock plans.

Retirement Plans

Cash or deferred arrangements (CODA) commonly referred to as "Section 401(k) plans" allow employees to defer taxes on amounts set aside for retirement while allowing a current deduction to employers. A good 401(k) plan can give employees a long-term outlook on their jobs. One problem associated with a 401(k) plan is that the plan must satisfy numerous requirements, and must pass a discrimination test based upon contributions made by the highly compensated and the non-highly compensated employees. To encourage participation, some companies match contributions made by employees.

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The rules applicable to 401(k) plans can be restrictive, and the implementation and operation of such a plan requires a commitment of administrative resources. Nevertheless, employers of all sizes have adopted such plans, both to provide employees with a tax-favored savings vehicle and to remain competitive in the ability to attract and retain such employees.

Health and Welfare Plans

Most companies will offer basic medical, disability, and life insurance plans. The funding mechanism is insurance and the company will usually require employee payment for spousal and dependent cover-age. Many companies that require payment for spousal and dependent coverage institute a cafeteria plan that allows employees to pay for the coverage on a pre-tax basis (both income tax and employment tax.)

In terms of disability insurance, if companies require the employees to pay the premium (which is usually very small), the employee will not be taxed on any disability payments received.

Bonus Plans

Most companies have both a short-term and a long-term bonus plan. The short-term bonus plan is often broad-based, whereas the long-term bonus plan is limited to a more select group. Both types of plans are based on reaching critical business and financial

goals. The company should consider the effectiveness of the broad-based short-term bonus plan. Although many early-stage companies do not elect to provide employer matching 401(k) contributions, the company could use the cash otherwise used for the broad-based short-term bonus plan as a match for the 401(k) plan to help in meeting the discrimination test. To the extent the money is vested when contributed to the plan, it is treated as if the employee contributed the money.

Other

Insurance

There are several categories of insurance that should be maintained in order to protect the assets of the company. A brief description of the basic types of insurance follows.

1. Workers compensation - This insurance is usually required by the State in which the company operates.
2. Liability - This type of coverage will insure for negligence against injuries resulting in the place of business or while traveling.
3. Property - This type of coverage will insure inventories, facilities, furnishings, and equipment from fire, theft, etc.
4. Key person life - This type of coverage insures for business interruptions and/or financial loss due to the death of a key officer or owner.

Insurance coverage should be reviewed regularly with an insurance agent familiar with your type of business.

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State Sales Tax

It is the obligation of the company to secure a “resale number” and remit to the proper collection authorities any sales tax collected. Resale numbers also authorize vendors to sell goods to the company without collecting sales tax, if the items purchased are for resale to others.

When selling the product to customers, it is the company’s responsibility to collect and remit any sales tax on goods that are not for resale. If a customer indicates that the goods purchased are for resale, the company should obtain a resale card from that customer and keep it on file. If there is no resale card/number for a customer, the customer should be invoiced for sales tax. If there is a sales tax due and not collected from the customer, the company may be held responsible for payment.

Accounting Periods

Periodically, the accounting books must be closed and financial statements produced. Options for accounting periods are as follows:

1. Every calendar month - this is the most typical accounting period used.

2. Every 4 weeks - 13 four week periods per year. Beware, however, that some computer general ledger packages will not allow more than 12 accounting periods per year.
3. Two 4 week periods and one 5 week period per quarter - this method is easy to manage but will distort the earnings and expenses for the period with 5 weeks in it.

Be sure that the accounting period selected fits with the natural business rhythm of the company. Also, inform the Company's banks of the day the statements are to be prepared. Banks are capable of creating bank statements on any banking day. Having a bank statement cut off on the accounting month end simplifies the bank reconciliation process.

LEGAL ISSUES FOR EARLY STAGE ENTREPRENEURS



Legal Issues for Early Stage Entrepreneurs

By Sullivan & Worcester LLP*

GETTING STARTED

CHOOSING THE RIGHT VEHICLE FOR YOUR BUSINESS

Most entrepreneurs have heard of the numerous choices that exist for legally organizing their business: e.g., corporations versus limited liability companies (LLCs), Delaware entities versus Massachusetts entities, C corporations versus S corporations. To add to the confusion, some of these descriptive categories overlap, and so it is possible to be a Massachusetts S corporation or a Delaware limited liability company.

The Basics

When considering which entity is right for your business, you can reduce the confusion by breaking down the decision into three component choices. The first choice is between a corporation and an LLC. This choice essentially boils down to a tax decision (explained below) of being taxed either like a corporation or like a partnership. If you choose to organize the venture as a corporation, the next choice is also a tax choice: between being taxed as a C corporation (the default rule, *i.e.*, how you will be taxed if you do not timely file with the IRS the appropriate election to be an S corporation), or as an S corporation (which requires a special tax election and has strict eligibility requirements, as explained below). Finally, you must choose the jurisdiction of organization, *e.g.*, Delaware, Massachusetts, or New York. The tried and true method is generally to go with Delaware because it has market acceptance, a highly developed body of law, special courts devoted to corporate issues, and tolerable fees for company filings and the like. Finally, most venture capitalist investors will insist that you reincorporate in Delaware if you did not organize there in the first place. (Only in rare cases are offshore tax-haven jurisdictions like Bermuda or the Cayman Islands appropriate.)

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Even if you begin as an LLC or an S corporation, your company may have to convert to a C corporation sooner or later. That is because the standard techniques for compensation (restricted stock, incentive stock options) and for equity financing (angel rounds, venture capital) are either extremely difficult to implement or simply incompatible with continued classification as an LLC or S corporation. In many cases then, the choice of entity is not so much about choosing a permanent format for your business, but more about whether the potential tax benefits of starting as an LLC or S corporation outweigh the attendant documentation and income tax compliance burdens of doing so.

It's All About Taxes

To understand why an LLC or an S corporation is considered more favorable than a C

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corporation for income tax purposes, you first must understand how a C corporation is taxed. The C corporation tax regime imposes two layers of tax: the corporation is taxed on its net income (if any), and the stockholders also are taxed when they receive dividends or liquidation proceeds from the corporation. These two layers of income tax can result in a combined income tax rate of 65% or more on income earned by the C corporation. Also, start-up losses incurred by a C corporation cannot be used on its owners' personal income tax returns.

In contrast, both LLCs and S corporations are “flow-through” (also known as “pass-through”) entities, which means that there generally is no income tax imposed on the company itself. Instead, the company's owners must include their share of the company's income on their personal income tax returns and pay tax on it. (The owners get sufficient cash out of their company tax-free to pay these increased personal income taxes.) Perhaps more important, the start-up tax losses incurred by an LLC or S corporation can flow through to its owners to use on their personal income tax returns. In general, however, owners can use these start-up tax losses on their personal income tax returns only to the extent of the amounts they have actually invested in the company.

Going with the LLC

Now that LLCs have been part of the common legal landscape, most lawyers are familiar with them and their organizational documents. The problem with LLCs is that they become complicated once the company begins to issue equity to compensate employees or to attract financing.

On the compensation front, an LLC cannot issue incentive stock options, something which key people joining your company generally are going to expect. Although an LLC can issue nonqualified stock options and restricted stock interests, doing so is generally complicated from documentation and income tax compliance standpoints (*i.e.*, bigger legal and accounting fees). Finally, if you have foreign employees or foreign investors on your team, their ownership of equity or options in the LLC could subject them to U.S. tax payment and filing obligations, whereas they might not have these responsibilities if your company were a C corporation.

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On the financing front, there are comparable issues with an LLC's issuing equity, convertible debt, or warrants to investors. Issuing these types of securities generally raises documentation and income tax compliance complications (*i.e.*, bigger legal and accounting fees). Also, venture capital funds are often backed by foreigners or tax-exempt institutions, who do not want to invest in “flow throughs” like LLCs because, to do so, subjects them to U.S. tax payment and filing obligations that they would rather avoid. As a general rule, venture capital funds do not like to invest in LLCs, and will insist that you convert your company to a C corporation before they invest.

Perhaps the biggest issue in choosing the LLC format is whether the company can, if necessary, later convert to a C corporation tax-free. The answer to this is a qualified yes. With two significant exceptions, it is generally possible to convert an LLC to a C corporation tax-free. First, the conversion may involve the owners recapturing on their

personal income tax returns some of the start-up tax losses that they received during the LLC flow-through period. Second, if the company issues significant equity to employees at, or around, the time of its conversion, the conversion itself may be fully taxable to the owners. For example, in cases where an LLC has put off issuing equity to its employees because of the attendant documentation and income tax compliance costs, there are pent up equity issuances waiting to happen which, if significant, could render the conversion itself fully taxable.

Shooting for S Status

Like an LLC, an S corporation is a flow through. However, the documentation and income tax compliance for an S corporation is simpler than for an LLC. Also, an S corporation can issue incentive stock options, the conversion from S corporation status to C corporation status will almost always be a tax-free event, and it is possible for an S corporation to be acquired by a public company in a tax-free merger. An LLC, by contrast, has none of these advantages.

Unfortunately, S corporation status has strict eligibility requirements, and is thus not always available. For example, an S corporation may only have U.S. individuals and electing U.S. trusts and estates as shareholders, and so corporations, investment funds, partnerships, or other entities or foreigners as shareholders will immediately terminate S corporation status. In addition, an S corporation cannot have preferred stock outstanding, and so this popular method of financing (particularly for venture round financing) is incompatible with continued S corporation status.

So where a new corporation can meet the S status eligibility requirements, it may make sense to elect S status, particularly where the prospects for venture round financing (or other S status terminating event) are not imminent. Also, if someone comes along who wishes to acquire the assets of the company at an attractive price, the selling stockholders will avoid two layers of taxation. The election for S status must be filed with the IRS within 2½ months of the company's formation. If this deadline is missed, the company must wait until the following tax year to make an S election, and even then, the tax rules will never be as favorable as if the company had S status from the outset. With S status in place, the corporation and its shareholders will get the benefits of flow-through tax treatment: single layer of tax on income, and flow through of losses. The price for these flow-through benefits is some additional income tax compliance costs, particularly where the owners reside in a state different from where the S corporation is doing business.

Conclusion

The proper choice of entity for a new business is necessarily a fact specific determination. Experienced legal counsel will focus on the tax attributes of the business and its owners, and then navigate with you through the range of potential choices. That said, it is possible to draw some broad conclusions on choice of entity issues. First, stick with Delaware as the jurisdiction of choice, unless you have fancy tax issues and need to look into offshore companies. Second, an LLC often makes sense for real estate businesses, some service businesses, and investment funds, but the LLC structure is cumbersome in situations where employees or investors will have an equity stake in the

business. Third, an S corporation makes sense when it is possible to comply with the strict eligibility requirements, but this S status will be transitory (and may not be worth the effort) where venture funding or some other S status terminating event is imminent. Finally, the C corporation, though the least tax efficient choice, is often the simplest from a documentation and income tax compliance standpoint, and many LLCs or S corporations will wind up a C corporation in the end anyway.

LEASING OFFICE SPACE

Leasing new office space is an event that can have major implications for any business. If a company leases space which ultimately turns out to be unsuitable for all its operations or if the lease does not allow for expansion space or the ability to sublease and relocate to new premises, the growth of the company can be unduly hindered. If too much space is leased, the company may end up wasting limited cash resources on something it does not currently need.

Leases are often detailed contracts extending over a number of years. A great number of points beyond rent and square feet can directly and adversely affect a business tenant. Sometimes developmental stage companies are misled into signing what a landlord describes to them as a “standard lease.” It is a rare lease that cannot be improved upon by a lawyer’s review, and this is as true of a so-called pre-printed form as it is for a lease that has been drawn up for a particular landlord by its lawyer. Forms created by real estate boards tend to favor their membership (the landlords), although the degree to which they succeed varies; what is clear is that these forms are not drawn up with the interest of the tenant in mind. Office space needs can be generic, but office space is still not a commodity, and should not be treated as such.

The following lists key issues that a prospective tenant should consider when entering into a lease:

The Premises: Do you know exactly what you are leasing? A precise plan showing the premises should be attached to the lease as an exhibit. The exact square footage of the premises should also be set forth and the means of its measurement described; and, if the tenant is to pay for taxes and operating expenses based on the ratio of the square footage of the premises to the total building square footage, those two numbers must be measured consistently and some investigation should be made to assure that sharing of costs on a square footage lease will be equitable – special uses requiring large amounts of utilities, for example, could result in one tenant subsidizing the cost of another. In the event future space needs are indefinite, an option to expand into or a right of first refusal with respect to additional space in the building should be considered. If all or substantially all the building is being leased, an option or right of first refusal to purchase the building may be appropriate.

Parking/Storage: The exact number of parking spaces, their location, their additional cost, if any, and whether parking spaces are assigned or used in common with other tenants, should be clearly set forth in the lease. Any storage space should also be identified.

Identity of the Tenant: This issue should be resolved up-front. If the tenant is a single purpose entity, will the landlord insist on personal or parent company guarantees or will it be satisfied with (and can the tenant afford to part with enough cash to obtain) a security deposit or letter of credit (and if so, in what amount)? If the tenant is a sizable partnership, can the general partners be exempted from liability beyond their interest in the partnership assets?

Permitted Uses: The permitted use clause, if any, should be as broad as possible so as to permit all contemplated uses of the premises and all incidental uses (including uses of potential subtenants). An attempt should be made to assure that all permitted uses are permissible under applicable zoning laws and regulations either by independent verification or a representation by the landlord.

Initial Construction: Unless the space is to be taken “as is”, perhaps the most significant item to be explored in full is the nature, timing, and responsibility for the performance and cost of the improvements to be constructed.

Tenant Construction: If the tenant is to perform the work, it should investigate whether it will have access to parking areas, loading docks, and elevators at times its contractor needs them, whether any code violation by the building will be corrected by the landlord prior to the time the tenant applies for a building permit, whether the landlord intends to charge it for construction period electricity or landlord supervisory fees, or impose rules and regulations covering matters such as noise and trash removal which may increase costs. (In addition to negotiating a suitable free fixed rent period during which construction is to be carried on, the tenant should also negotiate the applicability of charges during that construction period for the landlord’s operating expenses and taxes, charges which most landlords pass on to tenants throughout the “term of this lease” (which usually commences on the date the landlord delivers the space to the tenant)). If the landlord is to reimburse the tenant for construction costs, the timing of reimbursement should be detailed and the tenant should raise the possibility of a rent offset right if such payment is not made when due.

Landlord Construction: If leasehold improvements are to be constructed by the landlord, the tenant will want the lease to require that the substantial completion of such work and the issuance of a certificate of occupancy for the premises be conditions which must be met prior to the commencement of the lease. If such work is not completed by a certain date, the tenant will also look for a right to terminate the lease; only in unusual cases can the tenant obtain the right to bring an action against the landlord for damages for late completion (even though the tenant may have to pay holdover rent at its existing location or incur other costs as a result). The landlord should covenant to complete punchlist items promptly and without materially interfering with the tenant’s use of the premises. The tenant should request that the landlord guarantee that any landlord construction would be free from defects for a period of at least one year. The tenant should have some period of time, such as 60 or 90 days after commencement of the term,

to identify obvious defects in the work, and a longer period of time to identify latent defects, both of which the landlord should be required to correct.

The best way to avoid disputes relating to scope and cost of the work to be performed by the landlord is to attach construction drawings to the lease showing the work to be performed. If this is not possible, there should otherwise be a full understanding of what constitutes “building standard” work (both in quantity and quality), as well as other work which the landlord will complete, and whether or not all or any part of it is to be done at the landlord’s or the tenant’s expense. The situation in which most surprises occur is where the landlord has given the tenant a leasehold improvement allowance toward the cost of the improvements (usually a dollar per square foot amount), above which the tenant is responsible. In these cases, the tenant should be fully familiar with construction costs, should carefully detail what additional costs may be incurred due to tenant’s change orders, and should understand the overhead, supervision, general conditions, and profit fees which the landlord may seek to charge as part of the “cost” of the work. In any instance, the tenant should try to fix the amount of any costs for which it is responsible prior to construction.

Operating Expenses: If the tenant is to share in the cost of operating expenses for the building, the definition of operating expenses should be negotiated carefully. Many tenants successfully seek to exclude capital items (with certain limited exceptions, such as capital expenditures for cost savings devices or replacements of worn out items) from operating expenses. Determination of operating expenses in accordance with generally accepted accounting principles and certification of such operating expenses by an independent certified public accountant give some added protection to a tenant. (The description (once negotiated) of what is and is not an appropriate expense frequently goes on for many pages.) If operating expenses are to be paid over a base amount, that base should, if possible, be the first full calendar year during which the lease is in effect, and should be “grossed up” to reflect full occupancy by tenants paying fair market rent. Some tenants attempt to negotiate a cap on increases in operating expenses during the term of the lease. The tenant should request the right to review the landlord’s invoices relating to operating expenses.

Taxes: If the tenant is to share in the cost of taxes assessed to the building, the tenant should also receive its share of any refunds and abatement amounts (although in the case where the tenant pays the share of increases over a base amount many landlords, if not most, refuse to share with the tenant any reduction that causes taxes to be reduced below the base). In addition, if the tenant is leasing a substantial portion of the building, the tenant should have the right to require the landlord to pursue abatement proceedings, although in Massachusetts the tenant has certain statutory abatement rights. From the tenant’s perspective, the lease should also require the landlord to spread any assessment for betterments over the longest period permitted under applicable law. If taxes are to be paid over a base, the base should, if possible, be the first full fiscal tax year during which the lease is in effect, grossed up to full occupancy by tenants paying fair market rent.

Maintenance and Building Services: The landlord should have the obligation to maintain all structural elements of the building, including the roof, the exterior walls, the floor slabs, the common areas and facilities, and glass in all of the windows. If the landlord is to provide them, the lease should include detailed times and standards for building services (HVAC, cleaning, security, elevators, *etc.*) and set forth the additional cost, if any, for off-hours or additional services such as weekend or evening air conditioning or heating. In addition, the tenant should try to negotiate an abatement of the rent in the event an interruption of services or a repair failure continues for a specified time period and adversely affects the tenant's operations.

Insurance: The lease should include a covenant by the landlord to ensure the building in which the premises are located for its full replacement cost and should include a waiver of claims by the landlord for any damage covered by insurance and a commitment by the landlord to obtain a waiver of subrogation from its insurer (whereby the insurer agrees that it will not, having paid the landlord for damages which may have been caused by the tenant, turn around and sue the tenant). Even if the lease does not require it (most do), the tenant should carry "contents" insurance on its personal property located in the premises.

Compliance With Law: The obligation of the tenant to comply with law may obligate the tenant to make costly capital expenditures resulting from changes in the law, even though not necessitated by the tenant's particular use of the premises. In many instances this is not a proper result and many leases detail only limited conditions under which the tenant is responsible for the performance and cost of such work.

Reciprocity of Certain Obligations: Sections in a lease which obligate the tenant to pay for the cost of the enforcement of the lease and to provide estoppel certificates (certificates as to the status of the lease) should be made reciprocal, if possible.

Landlord Default: Although in most instances the landlord will resist the concept and in many cases the tenant could not practically avail itself of the remedy even if it had it, some tenants negotiate a "self-help" right which allows the tenant to cure the landlord's failure to comply with certain lease obligations. Some self-help clauses allow the tenant the right to offset against its rent obligation any costs it incurs in curing such failures.

Assignment and Subletting: The tenant will want as much flexibility as possible in the assignment and subletting clause. Assignments or subleases to entities controlled by, controlling, or under common control with the tenant, or arising out of merger or consolidation by the tenant with other entities, should usually not require the landlord's approval, lead to the landlord sharing profit, or afford the landlord a termination right. The landlord should be requested to act reasonably in determining whether to consent to any other subleases or assignments. The tenant should attempt to keep at least some of the profit on a sublease or assignment; if it must share some of the profit with the landlord, care must be taken to define "profit," which, from the tenant's perspective, would be defined as the excess rent less all expenses associated with the subleasing

and/or assignment, including leasing commissions, leasehold improvements, legal fees, and vacancy time.

Future Improvements: The landlord's right to approve any additional improvements that the tenant may wish to construct should be reviewed to assure that the landlord's concerns will not result in the tenant's inability to adapt the premises to its needs over time. Some leases state that the landlord's consent is not required for improvements which are merely decorative in nature (carpeting, painting, and the like).

If there are preliminary plans or descriptions of improvements which the tenant contemplates for the premises, they should be pre-approved and identified in the lease. The lease should also specify whether any alterations (including the initial build-out) must or may be removed at the expiration or termination of the lease.

Casualty/Condemnation: In the event of casualty or condemnation, the tenant will desire to be able to terminate the lease if restoration has not commenced, or is not completed, within a given period of time (regardless of so-called "force majeure" events beyond the control of the landlord). The amount of time will be a function of how long the tenant can function in temporary space waiting for the damage to be repaired. The tenant will want the rent to be abated equitably until any damage is restored.

Tenant Default: The tenant should receive notice of any default (both monetary and non-monetary). There should be a grace period after notice which is long enough so that the tenant is sure to be able to effect cure within that time. "Repeat offender" clauses (where notice is not required if the tenant defaults more than once or twice in any calendar year) should be minimized.

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Title Issues: In Massachusetts, if the term of the lease including all extension rights exceeds seven years, a notice of lease must be recorded to assure protection of the tenant's leasehold interest from invalidation by mortgagees or purchasers who have no notice of the lease. Whether or not lease language provides for the superiority or subordination of the lease to mortgages, the tenant should request a nondisturbance agreement from each present mortgagee, and language obligating the landlord to obtain such an agreement from all future mortgagees if the lease is to be subordinate to such mortgages. Otherwise, if the landlord's lender were to foreclose on its mortgage due to the failure of the landlord to pay its loan, as if the property is sold to a party not having notice of the tenant's lease, the tenant might find that its lease had been terminated by that foreclosure or sale.

Brokers: Brokerage disputes occur now more frequently than in the past, and landlords properly insist on knowing which brokers the tenant has had a relationship with who might then look to the landlord for compensation. The tenant should make sure that no brokers other than those identified in the lease have the possibility of claiming a fee due to any relationship with the tenant.

Security Deposit: If the tenant must provide a security deposit, the tenant should consider posting a letter of credit instead. Landlords generally resist agreeing to place a

security deposit in a segregated account or to pay interest. The tenant runs the risk of having a new owner or a foreclosing lender refuse to refund a cash security deposit at the end of the term of the lease, and landlords also frequently prefer letters of credit due to certain bankruptcy concerns applicable to cash security deposits.

Landlord Access: The tenant should request that any access to the premises by the landlord be preceded by notice and be accomplished (particularly in the case of access to perform repairs and improvements) at times and otherwise in such a fashion as will avoid interference with the tenant's business.

Extension and Expansion Options: The tenant will generally wish to obtain term extension options and if appropriate space expansion options, but to postpone as long as possible the time by which it must exercise any such right. If rent for an extension period is to be determined on the basis of fair market value, the tenant should try to have the fair market analysis reflect the cost savings to the landlord in leasing to a renewing tenant as opposed to having to bring in a new tenant. The tenant should also try to exclude the value of improvements which it has paid for in the determination of fair market value, so that it does not "pay twice" for those improvements. If possible, the tenant should have the right to withdraw its election to extend if the fair market value determination (presumably arrived at by arbitration if the parties cannot agree) is too high.

Signs/Building Name: The building directory should list all names (individuals and entities) the tenant desires. Negative covenants should be negotiated if the tenant would disapprove of the naming of the building or exterior signs of a competitor.

Integration Clauses: Many leases have so-called integration clauses. These state that the lease contains all the agreements between the parties relating to the premises. If there are any understandings that are not spelled out, they should be, otherwise the tenant may not be able to enforce them. This frequently applies to situations where the tenant thought it would have rights to additional space, have express obligations of the landlord to deliver space at certain times, or have rights to sublease or to terminate the lease prior to its scheduled expiration.

Special Circumstances: Subleases and leases of space in condominium buildings add additional levels of concern. The subtenant must not only review the original lease out of which its sublet space has been carved (since generally it must comply not only with the provisions of the sublease but the lease as well) but also carefully identify which party (the sublessor or the original landlord) is responsible for performing the standard landlord obligations (*i.e.*, access, HVAC, cleaning, security, *etc.*). An extra effort is required in the case of a condominium lease. There the tenant must review the master deed to assure itself, for example, that units may be leased at all, and if they may be leased, that they can be used for the particular use envisioned (office, retail, *etc.*); such a tenant should also determine whether the trustees of the condominium or the unit owner is responsible for performing customary "landlord" obligations. The tenant in a condominium should receive written approval of the lease from the condominium trustees and the subtenant should obtain approval of the sublease from the building owner. Rent-an-office shared

tenant services arrangements, which sometimes include secretarial services, delivery services, *etc.*, are usually offered on a take it or leave it fashion; generally, the only terms that can be negotiated are the rent, the price for the various services, and the term of the agreement.

Practical Considerations: While the sale of a building can occur, and if it does, it may result in a change of management, it is always a good idea to ask existing tenants about their satisfaction with any building a tenant is considering. Brokers are also often excellent sources, but it could be a mistake to rely exclusively on any advice from a broker whose sole or main source of commission is the owner of the target building. Similar companies which have recently investigated the market for comparable space often offer the best potential for an overall analysis of various possibilities; and in addition to their technical expertise, lawyers who specialize in leasing can also be a good source for trends, market conditions, and transaction structuring.

PROPRIETARY INFORMATION: HOW TO PROTECT YOURS

Legal protection of intellectual property is critical to technology dependent or driven businesses. It is particularly important to many start-up companies whose products are based on emerging technologies. The discussion below explores the various options for protecting intellectual property.

Intellectual Property

The term “intellectual property” covers a wide variety of intangible property rights, including concepts, processes, ideas, methods, formulas, practices, results, and goodwill. Legally protectable intellectual property falls into four principal categories: copyrightable material, trade or service marks, patentable material, and trade secrets. There is necessarily some overlap among these categories, and a particular intangible property right may fall into one or more categories. In addition, further protection for intellectual property may be provided by private contract.

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Copyright

Availability: Copyright protection is available under federal law for any “original work of authorship fixed in any tangible medium of expression.” “Originality” requires that the work be created through the independent effort of the author. Copyright protects only the manner in which an idea is expressed, not the idea or content itself. Abstract ideas, processes, methods of operation, facts, and utilitarian objects are not susceptible to copyright protection, but may sometimes be protected by trade secret law or patent law. Copyright protection is available for original computer programs, regardless of the language in which written. The copyright protection also protects machine code translations of such programs.

Ownership: The employer is usually the owner of the copyright on a work created by an employee in the course of his or her employment. If the creator of the work is not an employee, he or she will own the copyright unless the work was created within certain statutory categories of works as a “work for hire” under a written agreement which provides that the work was commissioned by the company, in which case the company

that commissioned the work is the copyright owner. In most cases, however, the non-employee author of the work will own the work. In order for the commissioning party to own the copyright to the work, there must be a written assignment of the copyright. For example, in order to assure you own all relevant rights, you should use a carefully drafted agreement when you have software written by an independent third party programmer.

Rights of Ownership and Identification: The copyright owner has the exclusive right to reproduce, distribute, and prepare “derivative works” from the copyrighted material. Copyrights can be transferred or licensed. In order to best protect a copyright in a published work, it should carry a copyright notice. The following form is recommended:

Copyright (year of publication)
(Name of copyright owner)
All Rights Reserved

The symbol “©” may be used in addition to or in place of the word “copyright.”

Copyright Registration: Registration of the copyright with the Library of Congress is optional, but is a prerequisite to a suit for copyright infringement. Under current law, works copyrighted by an individual are protected for the life of the author, plus fifty years. Works copyrighted by a business entity are protected for 75 years from the publication of the work or 100 years from its creation, whichever expires first. Works copyrighted under older law may be protected for different periods. The copyright registration process is relatively straightforward and can be accomplished for modest cost.

Trademarks and Servicemarks

The purpose of trademarks or servicemarks is to identify the source of the product or service (*e.g.*, the brand name). The major purpose of trademark law is to prevent confusion among consumers as to the source of goods or services. A person who has rights in a mark may exclude others from the use of the same or a similar mark in connection with goods or services in circumstances which may result in confusion by consumers.

Rights of Ownership: Ownership of a trade or service mark allows use of the mark to identify the owner as the source of particular goods or services. Depending on the “strength” of the mark, the breadth of the class of goods or services to which the right pertains may be greater or smaller. Where a mark is fanciful and contrived such as “Exxon” or “Kodak”, the mark is highly unlikely to also identify another party who is not intentionally using the mark to trade on (or “dilute”) the reputation of the first. Hence, exclusive rights to such a mark in the protected market area may extend significantly beyond the goods or services on which it is currently used by the owner. Conversely, a “weak” mark such as “Ace” or “Supreme” may not be afforded protection beyond the products or services on which it is used. If the owner allows the mark to become synonymous with the goods or services, the owner runs the risk that proprietary rights will be lost, because the name may be deemed to have become “generic” and, thereby, no

longer identify a source but, instead, a good or service available from several sources. “Kleenex” and “Frigidaire” are good examples.

Availability: Trademark and servicemark protection is available under both federal and state law. It is not necessary to register a mark in order to obtain the basic rights afforded under state law. Rights in a mark arise upon its use in commerce in connection with a particular good or service. Registration of a mark is required before federal protection is given. Generally, state protection is limited to the geographic area in which the mark is used; federal protection extends the owner’s rights nationally, including geographic areas in which the mark (or a very similar one) is not already in use. In addition, it is possible to obtain federal registration of a mark under an “intent to use” registration without actually using the mark in commerce prior to applying for registration.

One of the most difficult challenges a new company faces is finding an effective name that has not already been registered by someone else. A first screen review of a particular name’s availability can be accomplished online for a relatively modest cost. If, however, the name is, or will become, important to the goodwill of the business, it is advisable to retain a search firm to conduct a more thorough review and issue a comprehensive report. A simple search of this type takes about five business days and costs about \$300-400. Once the path is clear, a trademark registration can be accomplished for relatively modest costs but, unfortunately, not without significant delay. The Patent and Trademark Office has a significant backlog, and it typically takes six months to receive notice of the grant of the trademark.

Identification: Trade and service marks should always be identified as such when used in order to indicate that a proprietary right is claimed. The symbol “TM” and the symbol “SM” should be used to indicate claims of rights in trade and service marks which have not been federally registered. Federally registered marks can be identified by the “®” symbol. If you use a trademark belonging to someone else in an advertisement or for some other purpose, you should clearly indicate its ownership, for example: “HyperCard is a registered trademark of Apple Computer, Inc.”

Patents

A patent is a legal monopoly granted by the federal government to an inventor allowing the inventor to exclude others from making, using, or selling the invention during the life of the patent. It is issued to the individual inventor(s) and is assignable. Patent protection is available for any product, process, or design that meets certain requirements of novelty, non-obviousness, and utility. U.S. patent protection lasts for 20 years from the date on which the application was filed, with the exception of design patents, which last for 14 years from the date the patent was granted.

In the United States, a patent application may be filed no later than one year after a description of the invention is published, or the invention is first put on sale or made available for commercial use. In most foreign countries, patent protection is not available for inventions that are publicly disclosed prior to the filing of a patent application. As a result, if a company envisions sales or operations overseas, foreign patent protection may

prove important and legal advice should be obtained prior to publication, sale, or commercial use of the invention. Once the invention becomes public, foreign patent protection will be lost forever.

The Supreme Court has said that the scope of the patent laws is wide enough to include “anything under the sun that is made by man.” The statute also affords protection for the processes for making the products. But the statute has been interpreted to exclude patent protection for laws of nature, natural phenomena, and abstract ideas. Also, a patent cannot be obtained upon an idea or suggestion until it has been reduced to practice. Computer hardware is patentable, as is certain software. In the proper circumstances, a computer program can be part of a patented device (“machines” or “hardware”). Former Patent Office procedures examined whether a claimed invention recited a “mathematical algorithm” and was, therefore, tantamount to an unpatentable abstract idea or formula. This created doubt about whether a computer program or other business method could be patented. Present procedures now focus on whether the claimed invention as a whole produces a “useful, concrete and tangible” result, and, therefore, claims which protect business methods or the practical application of a computer program may be patentable.

Trade Secrets

Requirements: A trade secret is any information, formula, pattern, or device used in one’s business that gives a competitive advantage and is not generally known within the industry. It must be of continuing use and must be kept confidential. This last requirement is extremely important, because once the information is no longer secret, it is no longer protected. Only two types of subject matter cannot be protected as a trade secret: (a) abstract ideas or general principles not embodied in a specific form and (b) an employee’s own skills and general knowledge. A person or company claiming a trade secret must use reasonable and active procedures and controls designed to prevent disclosure and misuse. Leaving confidential materials lying around or within easy access can result in forfeiture of trade secret protection. Total or absolute secrecy, however, is not required. A trade secret can be communicated to employees who must use it, and it can be assigned, licensed, or otherwise disclosed to other persons who are required to maintain its confidentiality. If material is known to some part, but not all of the industry, trade secret protection may be available.

Limits to Protection: The protection is not absolute because third parties may independently develop the same idea or, when not restricted by contract, “reverse-engineer” a product to determine how it is made. Computer software is a proper subject for trade secret protection when it is marketed through license agreements. The fact that computer software may also, potentially, be protected by copyright, or, in some cases, patent illustrates the overlap between these areas of law and trade secret law.

Trade Secrets and Patent Law: Trade secret law can protect an idea or invention that does not meet the narrow, technical requirements for patent protection, for as long as the confidentiality of the idea or invention is maintained. As trade secret law protects only information that is not widely known, a trade secret must have some novelty to be protected, but nothing like the degree of novelty required for patentability. Trade secret

law is also useful in protecting subject matter which is appropriate for patent protection during the often-lengthy patent application process. This is possible because the Patent Office maintains applications in secrecy until and unless a patent is ultimately issued. Once a patent issues, the invention is made public and, therefore, would no longer be eligible for protection as a trade secret.

Where material is appropriate for both patent and trade secret protection, certain considerations arise in choosing a form of protection. For instance, patent protection lasts for only 20 years; trade secret protection lasts indefinitely. Patents give an absolute monopoly over use, while trade secret law gives no protection from independent invention or honest discovery or reverse engineering. The cost of trade secret protection is relatively small as compared to the cost of obtaining a patent. A trade secret that is relatively easy to keep secret and difficult to reverse-engineer or chemically analyze is usually well-protected by trade secret law and, therefore, may not need to be protected by a patent.

Trade Secrets and Copyright Law: Trade secret protection can exist together with copyright protection under certain circumstances. The use of a copyright notice does not automatically negate trade secret protection. If a work is unpublished or is subject to “limited publication,” it may continue to be protected as a trade secret. “Limited publication” is communication of the work “to a definitely selected group and for a limited purpose.” The licensing of a trade secret can fit this definition. Of course, if a general publication is made, trade secret protection is lost. In addition, trade secret protection is lost if the trade secret is disclosed in a copy of the work deposited with the Library of Congress as part of a copyright registration. (In recognition of the trade secret issues involved with computer software source code, the Copyright Office has special rules which allow the deposit of less than the entire work.) Unpublished works may be registered without a deposit. In order to reserve all options, unpublished works should carry the following notice:

Copyright (*year of creation*) (*owner of copyright*)
Unpublished - All Rights Reserved

Protection by Private Contract

Confidential Information: In discussions with prospective investors, prospective licensees or others, protection of your trade secrets and other confidential information ordinarily will require that you obtain the recipient’s agreement to maintain the information in confidence. An appropriate confidentiality provision may be included as part of a more comprehensive document which is to be signed by the recipient (*e.g.*, a software license agreement or a consulting agreement). In other circumstances, it may be appropriate to enter into a separate nondisclosure agreement. You may desire, or your investors may require, that employees sign similar confidentiality agreements. Your lawyers can provide these agreements, which should be executed before confidential information is disclosed. If you plan to seek patent protection for a trade secret, you should consult a lawyer about the consequences of marketing or otherwise disclosing the invention prior to the filing of a patent application.

Also, there are certain classes of professional advisors and investors that, as a matter of commercial practice, do not sign nondisclosure agreements. For example, lawyers and law firms generally do not sign nondisclosure agreements, but as lawyers they are bound by duties of confidentiality and loyalty to clients. In addition, venture capital firms will almost never sign a nondisclosure agreement before reviewing your business plan or your pitch. In these instances, the best that can be done is to mark your written submissions with some language like the following. (Please also note the additional language to address securities law issues, a topic discussed elsewhere in this Primer.)

The information contained in this document is confidential and proprietary to us and is being submitted to you solely for your confidential use with the express understanding that, without our prior express written permission, you will not release this document, discuss the information contained in it, or make copies of or use this document for any purpose other than evaluating a potential business arrangement with our company. This document is not an offer to sell securities, or a solicitation of offers to buy securities of the company. Any offer to sell securities of the company, if made, will be made by written offering materials and in compliance with applicable federal and state securities laws.

Of course, the above sample language should be tailored for specific situations, which may require either less or more detail. Your lawyers can give you guidance on what is most appropriate in particular situations.

Goodwill: Another proprietary right which you may need to protect by contract is the value of your relationships with your customers and other aspects of your business as a “going business.” In order to protect this “goodwill,” you may wish to restrict the ability of certain employees (typically, senior executives and some technical and marketing personnel) to use your customer or other information other than for your benefit, or to compete with your business for a period of time following the termination of their employment. A noncompetition agreement may have limitations in scope as to subject matter, geography, and/or time. The laws which affect the permissible scope and enforcement of noncompetes varies from jurisdiction to jurisdiction.

RELATIONSHIPS AMONG FOUNDERS: CONSIDERATIONS IN STRUCTURING RELATIONSHIPS AMONG MEMBERS OF THE FOUNDING TEAM

In the excitement and frenzy of starting a new business, founders may assume they all are of like mind. But contributions and commitments may diverge over time, and the successful resolution of the resulting tensions will depend, in large part, upon the extent to which they were anticipated and addressed in advance. The discussion below outlines legal and business issues that the founders of a new venture may want to consider in structuring relationships with one another. The discussion does not cover all potential issues, but is meant to stimulate thought and discussion. For example, although the

discussion below is explained in terms of founders owning stock in a corporation, comparable issues arise for founders owning equity in a partnership, limited liability company, or other business entity.

The primary concern for members of the founding team is the question of how the equity in the new venture is to be allocated, both initially and over time. Ownership of stock carries with it two attributes: economic participation in the venture and the right to have a say in decision making. These attributes can be structured in a variety of ways, including preferred economic returns and limited or expansive voting rights. To determine how to allocate these attributes, the following issues should be considered:

Initial Ownership/Contributions

Typically, each member of the founding team brings a unique skill or property to the venture for which he or she is to receive equity. It is important to understand that, unless the participants specifically agree otherwise, once stock is issued to a person, it is owned free and clear by that person. For example, assume that Amar, Akbar and Anthony are the founders and their understanding is that Amar will invest \$20,000, Akbar will work on marketing and financing and Anthony will develop the product. They agree that each will receive 1/3 of the stock. In this situation, Amar has done everything he promised once he pays his \$20,000. The founders should consider what happens if Akbar or Anthony does not perform as expected.

Vesting: One method of handling this issue is to “vest” ownership of the stock of the founders only if certain conditions are met. Vesting can take many forms. The founders might agree to a calendar vesting schedule (*e.g.*, straight-line vesting over 5 years), so that a founder who leaves the company after one year of employment or involvement would be entitled to keep only 20% of his or her stock. The 80% unvested portion would either be forfeited or repurchased by the company at cost. Calendar vesting can be viewed as a surrogate for the tasks each founder is to undertake. For example, it might be assumed that Anthony will complete the product within a year or, alternatively, if he doesn't, it may not matter because an opportunity window might have passed. Founders also need to consider whether a non-performing member can be required to leave, forfeiting his or her equity, which would then become available to attract a replacement. An alternative to calendar vesting is “milestone vesting,” which vests stock on the basis of achieving identifiable milestones, such as “first beta ship” or “prototype” completion. Obvious problems here are whether the milestones can be identified clearly and, even if they can, whether they will make sense if the product or business plan changes. Finally, should the stock of a founder become fully vested if his or her employment is terminated, and should that depend upon the reason for termination?

Income Tax Considerations: There are several important income tax issues which must be considered if vesting is selected. Although a complete discussion of these issues is beyond the scope of this discussion, an overview of some of them is attached as Exhibit A.

Early Estate Planning: Another important issue to consider at the outset is whether some portion of the founder stock should be subscribed for by relatives of the founders (*e.g.*, siblings, or a founder's children, or trusts for their benefit). Bringing these relatives into the company early allows them to participate in growth from ground zero, and is much cheaper from an estate and gift tax standpoint than transferring stock to the relatives at a later time when higher valuations may result in estate or gift taxes.

Scope of Economic Participation

Another question is whether a person whose stock has vested should be entitled to participate in the economic success of the venture after he or she leaves the company. The business issue is whether the person is to be rewarded only for the increase in the value of the venture until the time he or she leaves. If so, then either the company, the other founders, or both should have the right to repurchase the departing founder's stock at some price, perhaps the "fair market value" or an agreed value, a formula value, or an appraised value. Another reason for having a repurchase right is to prevent the dilution in ownership which would occur if the company has to issue stock to someone new who is taking over the departing founder's tasks. On the other hand, if the "deal" is that once the stock vests, a departing founder is entitled to participate in future increases (and be subject to future declines) in the value of the venture, then there is no need for such a repurchase right.

Transfers of Stock

Federal and state securities law restrictions on the issuance and transfer of securities are discussed elsewhere in this Primer. Subject to those laws, once stock has been issued, it can be transferred by the holder. But it may be in the best interest of the company and the other stockholders to restrict the ability of a stockholder to transfer stock. For example, without such restrictions a founder could transfer his or her stock to a competitor. Restrictions can take the form of a "right of first refusal" under which the company and/or the other stockholders have a right to match the price offered by a third party. Careful consideration needs to be given to the events which will trigger this right to buy back stock (*e.g.*, a third-party offer, death or disability, a desire for liquidity, *etc.*), and who has the right to initiate the transaction. The purchase price may be based upon a third party offer, or a formula price, or the Board of Directors could periodically set the price for all transactions in the company's stock.

If a stockholder is to be allowed to trigger the first refusal process by stating a general intention to sell at a given price without identifying a specific purchaser, consideration should be given as to whether the company should be allowed to step back in and purchase the stock when the specific purchaser is identified. This may be appropriate if the purchaser is perceived to be potentially disruptive.

Take-Along Rights

Although it is more commonly imposed by venture capital investors, founders sometimes agree among themselves that, if any one of them finds a purchaser for his or her stock, all will be able to participate in the sale, usually on a pro rata basis. These rights are sometimes called "take-along" rights, "tag-along" rights or "co-sale" rights. Sometimes

these rights are combined with a right of first refusal in order to provide the stockholders with the opportunity to purchase the stock if they think the proposed sale price is favorably low, or to sell their shares if they think the third party price is high.

Death/Disability

Founders should consider what should happen if one of the founders dies or becomes disabled. In the case of death, the stock owned by the deceased stockholder may end up in the hands of family members or be sold to pay debts or taxes. Since the other founders may not want the deceased stockholder's spouse, son, or daughter as a major stockholder, the company and/or the other stockholders often are given the right to purchase the stock owned by the deceased stockholder. This repurchase right could be funded by the proceeds of a "key man" life insurance policy. (In addition, the company may secure a life insurance policy to provide the company with operating funds until a replacement for the deceased stockholder/officer is found.)

The founders also should consider whether they want to give the deceased stockholder's executor the right to force the company to buy back the stock. This might be desirable where the estate of the deceased stockholder lacks the liquidity needed to pay estate taxes or expenses. This put right also could be funded by insurance, or each stockholder could purchase his or her own life insurance to provide estate liquidity. The optimal arrangement depends on a number of factors, including tax law considerations, which change over time and differ among individuals.

Determining the Repurchase Price

In the case of "rights of first refusal," the repurchase price often is set by the independent third-party offer or, when there is no specific offer on the table, by the selling founder. In the latter case, the protection for the company from significant changes in value over time is that the selling founder has a limited period of time (*e.g.*, 90 days) to sell the stock at a price no less than that offered to the company. If the founder does not consummate a sale within such period, he or she is again obligated to offer the shares to the company prior to a sale.

In the case of repurchases upon the death or disability of a founder, the determination of the repurchase price takes a variety of forms. When the founders agree that death repurchases will be funded by life insurance, enough insurance usually is purchased to pay the entire repurchase price. However, consideration should be given to the fact that the company may not always want to expend funds on insurance instead of growth. Because of this possibility, some agreements are drafted to provide that, while the repurchase price will be the "fair market value" of the stock, the company will pay the price in cash to the extent of any insurance proceeds and give the selling stockholder a note of the company payable over time for the balance.

There may be other situations when it is necessary or desirable to specify in advance a process for determining the repurchase price, such as repurchase of vested stock in the event of the termination of employment or repurchase instead of allowing stock to be

transferred to a spouse in a divorce situation. Sometimes it is possible to agree on a formula price for repurchases, such as asset value, or a multiple of earnings, or revenue.

However, these traditional formulae may be inappropriate in many technology-based new ventures where the value of the business consists of strategic relationships, intangible intellectual property rights in technology, or processes that have no existing markets. In these situations, the price can be determined in a variety of ways, including independent appraisals or by the Board of Directors in its discretion. If appraisal is chosen, the founders should consider how many appraisers will be required (*e.g.*, one chosen by the seller, one by the company, and one by agreement of the other two appraisers), what the qualifications of the appraisers should be, and what guidelines the appraisers should be given. There are obvious cost and delay considerations here. Sometimes the founders agree in advance that the price will be “fair market value” as determined by the company’s independent public accountants. This may be less expensive than a full appraisal performed by an independent appraiser, but the qualifications of the accountant to judge the value of a technology-based business should be considered.

Another approach is to have the Board of Directors periodically (*e.g.*, quarterly, semi-annually, *etc.*) determine the fair market value of the company’s stock and apply that value to all purchases and sales of stock, barring unusual circumstances. Before adopting the Board of Directors approach, the founders should ask themselves whether they have the discipline to follow through on a consistent basis. Many founders never find the time to hold formal Board meetings. From a business strategy and legal viewpoint, it is crucial to have formal meetings with outside Board members for these matters.

Payment of Repurchase Price

Payment Methods: Founders should also consider how the company or the purchasing stockholders will pay the repurchase price for stock. In “rights of first refusal” cases, some founders decide that the repurchase price must be paid in the same manner as the outsider offers to pay. Other founders decide that the company always should have the right to pay part of the repurchase price with a company note, because the company, especially a fast growing company, might not have the available cash when and if the time for a repurchase arises.

Notes: If it is decided that a note may be used, the general terms of the note should be discussed. In particular, founders should consider the interest rate (perhaps the company’s then-current bank rate), the term (five years is common), and the frequency of payments (monthly, quarterly or annually). Typically, it will be appropriate that the note be “subordinated” to bank or other debt of the company (*i.e.*, if there is not enough cash to pay the stock repurchase note and the bank debt, then the bank debt takes priority).

Other Choices: Sometimes founders adopt different payment approaches to different repurchase events. For example, they might choose a “match the offer” approach for rights of first refusal and a cash and note approach for death or disability repurchases.

Deciding which approach to adopt is primarily a matter of reaching a consensus on the philosophy under which the founders want to operate the business and deal with each other. In most situations, it is not possible to determine in advance which founder is most likely to end up being the seller of stock. Therefore, it will not be possible to figure out in advance who will be advantaged and who will be disadvantaged by the choices made.

Stock Transfer Restrictions

Will Transferees Be Bound? One of the major reasons for having a stockholder agreement is to keep the stock of a private company closely-held by employees and others who add value to the venture. The founders should consider whether some or all of the restrictions explained in this discussion should apply to persons who acquire stock in the company. For example, if a selling founder gives the company a right of first refusal and the company “passes,” should the purchaser be subject to the restrictions of the stockholder agreement? Some founders believe that requiring a purchaser to agree to these restrictions will depress the price the purchaser is willing to pay for the stock and that this burden on the selling founder is not appropriate if the company had its chance to buy but decided not to. The other view is that the company may not always be in a financial position to exercise its repurchase rights and that the closely-held model should be adhered to until holders of a majority of the stock agree otherwise, even if it may depress the price for a particular founder who wants to “get out early.”

Permitted Transferees: With any stock transfer restriction, it is appropriate to ask if all transfers will be subject to the restriction. For example, should a gift of stock to a spouse or child for gift and estate planning purposes be exempt from restrictions? What about a transfer from one founder to another? Even if the founders decide that such transfers do not invoke the restrictions, it is usual practice to have the transferee agree to be bound by the restrictions on subsequent transfers.

Preemptive Rights: Preemptive rights provide that the company cannot issue any additional stock, without giving the existing stockholders the right to purchase the additional stock. In this way, if the founders are willing to put more money into the company, they can avoid a dilution in their percentage of ownership in the company as a result of new stock issuances. Preemptive rights can be a valuable item to offer outside investors because it gives them a chance to maintain their level of ownership, but may deter potential investors in subsequent rounds.

If preemptive rights are adopted, consideration should be given to their duration. Obtaining waivers or abandonment of preemptive rights, as often is insisted upon by venture capital investors, becomes increasingly cumbersome as the number of stockholders increases.

Duration of Restrictions: The duration of restrictions should be considered. Do they apply indefinitely? Until a public offering? For a fixed term of years? It also should be kept in mind that, if outside financing is anticipated, the new investors will have their own ideas about restrictions.

Control: With stock ownership usually comes the right to vote for directors and have a say in major corporate events. Even with nonvoting stock, there are certain fundamental corporate transactions which require approval of a certain percentage of each class of security. Often the founders agree to vote their stock so that each has a seat on the Board of Directors. It is also common for the founders to agree that “Major Events” will require agreement of all, or a majority, of the founders. In addition to mergers or sales of all, or substantially all, the assets of the venture, Major Events could include incurring more than \$x of debt, entering into license agreements or distribution agreements for the company’s products, issuing additional equity or options, *etc.*

Proprietary Information

In most situations, the founders will want to provide that any inventions or discoveries made in the course of the venture will belong to the venture. When a founder is bringing certain technology to the venture, he or she may want a clear understanding of what rights the venture has in the technology. Who owns what if the venture fails? Can some, but not all, of the founders start another new venture? Is the venture to be limited to exploiting a technology in a particular niche? Whatever the initial agreement among founders may be, later investors may require, as a condition to their investment, that all rights to a technology be transferred to the venture.

Employment

Is the continued employment of one or more founders considered important either to the founders being employed or to the other investors? Under what conditions can a founder be terminated and what consequences does this have to his or her stock ownership? What if major differences arise about the direction of the venture, such that the services of a particular founder are no longer needed?

EXHIBIT A

Section 83 - Taxable Income From Stock Vesting

The Law

Section 83 of the Internal Revenue Code basically provides that if a person performs services for a company (whether as an employee or consultant) and receives stock, he or she will be deemed to have received income when the stock is received. However, if the stock is subject to a “substantial risk of forfeiture” (*e.g.*, vesting), then income is recognized when the risk of forfeiture lapses (*e.g.*, when the stock vests), or if a Section 83(b) election is made, when the stock is received. The amount of income is the excess of (a) the fair market value of the stock at the time income is to be recognized over (b) the amount, if any, paid by the person for the stock.

Discussion

Stock issued to founders, other key employees, advisors, or consultants is often made subject to restrictions to keep ownership within the group of key players. Such stock will usually have additional restrictions designed to provide incentives for these persons to continue to contribute to the success of the enterprise. For example, the stock may be forfeitable, in whole or in part, if the employee leaves the enterprise within a stated period of time, say 3 years. As a result of these restrictions, the day of reckoning for Section 83 purposes may be postponed for several years, because the stock will be subject to a substantial risk of forfeiture until it has vested. At that time, the value of the stock may be substantially above the nominal consideration (often \$.01 per share) paid by the stockholder. Fortunately, Section 83(b) allows the stockholder to elect to recognize income at the time he receives the stock, even if it is subject to a substantial risk of forfeiture. This election may lower the amount of tax payable by the employee if the fair market value of the stock increases over time. The Section 83(b) election must be filed by the stockholder with the IRS within 30 days of receiving the stock. Once the 30-day period expires, the ability to make the election is irrevocably lost. Because Section 83 defers the day of reckoning in the case of stock subject to vesting, the Section 83(b) election should be made even if the value of the stock at the time of purchase is equal to the purchase price.

Knowledge of Section 83 is critical to the manager working in a start-up business or in any situation where equity incentives are provided. Unlike many provisions of the Internal Revenue Code which impose tax when cash is received, Section 83 imposes a tax when stock is received or when restrictions lapse. This deferral can create a much greater than expected tax burden. If the stockholder does not have other sources of cash to pay the tax, he or she may be forced to sell stock to pay the tax. This could create a problem if there is no trading market for the stock or if the manager believes the stock is undervalued.

Example: Internet Widgets, Inc. sells 10,000 shares to Manisha, one of its founders, for a price of \$.01 per share (\$100 total purchase price, which is its fair market value). The stock is subject to vesting provisions under which, if Manisha leaves the employ of Widgets before the end of 4 years, she forfeits all of her stock. Assume that the fair market value of the stock at the beginning of each year of Manisha's vesting schedule is as follows:

<u>Year</u>	<u>Value Per Share</u>	<u>Total Value</u>
1	\$.01	\$100
2	\$10.00	\$100,000
3	\$25.00	\$250,000
4	\$45.00	\$450,000
5	\$75.00	\$750,000

Result: Unless Manisha files an election under Section 83(b) of the Internal Revenue Code within 30 days of receiving the stock, at the start of Year 5 Manisha will have taxable ordinary income of \$749,900 (\$750,000 fair market value minus her \$100 purchase price), even though she did not sell the stock and even if there is no market for the stock. Similarly, Internet Widgets, Inc. will be required to meet its own obligations to the IRS to withhold appropriate amounts from payroll for Manisha's \$749,900 of compensation.

COMPENSATION & FUNDING

INCENTIVE STOCK OPTIONS AND NONQUALIFIED STOCK OPTIONS

The typical “omnibus” stock option plan provides for the grant of both incentive stock options (“ISOs”) and nonqualified stock options (“NSOs”). The discussion below explains the business and tax differences between these two types of options.

ISO Requirements

Granting ISOs: ISOs may be granted only to employees of the issuing corporation or its subsidiaries. Thus, an ISO cannot be granted to a member of the board of directors in that capacity, nor to an employee of an LLC or a partnership. The ISO must be granted pursuant to a plan which specifies both the total number of shares that may be subject to options and who is eligible to receive options. The plan must be approved by the shareholders within 12 months before or after the date it is adopted by the board of directors. The option must be granted within ten years after the first to occur of the plan’s adoption or its approval by shareholders.

Exercising ISOs: An ISO cannot be exercisable after the expiration of ten years from the date of grant (five years in the case of an option granted to an owner of 10% or more of the voting power of the issuing corporation). During the optionee’s lifetime, the ISO may be exercised only by him, and by its terms it cannot be transferable other than at death. Further, unless the employee dies or is disabled, the ISO can only be exercised while he is employed, or within three months after employment ceases.

The ISO exercise price must be at least equal to the fair market value of the stock on the date of grant (if granted to a 10% owner, it must be equal to at least 110% of the fair market value). There is a limit on the maximum amount of ISOs that can first become exercisable by an individual in any calendar year. The limit is the number of shares corresponding to \$100,000 divided by the per share fair market value at the time of the ISO’s grant.

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Example: If all of the options that are ever granted to Akbar Employee are granted when the company’s stock has a fair market value of \$20 per share, the maximum number of ISOs that can first become exercisable by Akbar in any calendar year is 5,000. Thus, if Akbar is granted an option for 50,000 shares at the \$20 exercise price, his option could not vest (that is, become exercisable) more rapidly than at the rate of 5,000 shares per year (that is, 5,000 per year x \$20 = \$100,000 per year) if the option is to qualify in its entirety as an ISO. However, there is no restriction on Akbar carrying over to a subsequent year and exercising in a subsequent year all of his ISOs that became exercisable in a prior year or years. Nor is there any problem with having a large number of NSOs becoming exercisable by Akbar in the same year as his ISOs.

ISO Tax Treatment

For federal income tax purposes, no tax event occurs when an ISO is granted. When an ISO is exercised, the optionee does not recognize any income for regular federal tax purposes. If the optionee meets the ISO holding period requirements discussed below,

the optionee will recognize income for regular federal tax purposes only when the optionee disposes of the stock, which the optionee received when he or she exercised the ISO. The optionee's income at that time will be measured by the difference between the excess, if any, of the sales price over the option exercise price, and will be treated entirely as long-term capital gain income.

Alternative Minimum Tax: However, when the ISO is exercised, the difference between the exercise price and the value of the stock at that time is treated as a preference item for purposes of the individual alternative minimum tax ("AMT"), which currently is imposed at a maximum rate of 28%. While the AMT is unlikely to be an issue for a rank-and-file employee, highly compensated individuals may be subject to the AMT (or become subject to it because of ISO exercises), with the result that they experience little or no tax advantage from receiving ISOs rather than NSOs. The better the performance of the company's stock, the larger the AMT preference item will be when the ISO is exercised, and, therefore, the greater the chance that the AMT will apply at that time.

To the extent the AMT does apply, an AMT tax credit will be available to offset the regular tax inclusion that occurs when the stock acquired under the ISO is ultimately sold; in other words, the AMT can accelerate tax but will not give rise to a double tax.

How to Achieve Favorable Regular Tax Treatment: In order to receive the favorable regular tax treatment of an ISO that is described above, the optionee cannot dispose of the stock acquired upon exercise within two years from the date of the option grant nor within one year from the date of exercise (a "Disqualifying Disposition"). As a practical matter, this means the employee will have to fund payment of the exercise price from some source other than selling the shares acquired, or else some of the ISO benefit will be lost. This also means that shares acquired upon exercise of an ISO cannot be disposed of in a liquidity event without loss of ISO benefits, unless the liquidity event occurs at least one year after exercise and at least two years after the grant of the option.

Disqualifying Dispositions: If a Disqualifying Disposition does occur, the optionee will recognize ordinary income at that time based on the difference between the Disqualifying Disposition sales price and the option exercise price or (if less) the difference between the fair market value of the stock at the time of exercise and the option exercise price. If the stock has appreciated after exercise, that appreciation is taxed as capital gain income.

Example: Bina Employee receives an ISO in 1997 which has a \$20 per share exercise price. In 2000, she exercises an ISO on one share when the shares are trading at \$50, and six months after exercise she sells the share for \$60. Because Bina has not held the stock for one year, she has a Disqualifying Disposition. Bina is treated as having ordinary income in 2000 of \$30, and a short-term capital gain of \$10.

There is no income tax withholding or social security (FICA) tax in connection with an ISO, even if a Disqualifying Disposition occurs. Of course, however, the employee remains responsible for any income taxes on her ordinary income or capital gain from a disposition of shares acquired upon exercise of an ISO.

Tax Consequences for the Issuing Corporation: The issuing corporation normally does not receive any tax deduction in connection with an ISO. However, if a Disqualifying Disposition occurs, the corporation receives a tax deduction equal to the ordinary income recognized at that time by the employee. In order to enable the employer to claim the deduction, a well-drafted ISO plan will require an optionee who has a Disqualifying Disposition to notify the company.

NSO Requirements and Tax Treatment

There are no tax requirements concerning NSOs; any option granted to a person in connection with his or her performance of services automatically is treated as an NSO if it fails to meet the ISO requirements or, even if it meets them, if by its terms it provides that it will not be treated as an ISO. The only requirements concerning NSOs are those imposed by the plan and by applicable local law. (However, an NSO with only a nominal exercise price might be treated as an outright grant of the underlying stock under option, in which case the optionee will be taxable upon the vesting of the option in an amount equal to the underlying stock's then fair market value minus the option's exercise price.)

Tax Consequences to the Optionee: As with an ISO, an optionee does not recognize any income upon the grant of an NSO. However, when the NSO is exercised, the optionee recognizes ordinary compensation income equal to the difference between the exercise price and the value of the shares at that time. This compensation income is subject to income tax withholding and social security taxes. (If the employee does not have sufficient other compensation income on which the company can withhold the required income tax, the company must find a way to require the employee to furnish it with cash so the company can meet its income tax withholding obligations. Buying back some of the stock as soon as the employee exercises is one way to do this, but obviously this reduces the employee's participation in future growth and may also give rise to a taxable dividend.)

Once the employee has recognized ordinary compensation income under the NSO, he is treated like any other person who has purchased company stock: he has a holding period beginning on the date the compensation income occurs, any further gain or loss will be based solely on changes in the stock's value from the time the compensation income was recognized, and that gain or loss will qualify as long-term or short-term capital gain or loss income.

Exception to General Rule: In some cases, the stock acquired upon exercise of an NSO is subject to a "substantial risk of forfeiture," such as a vesting provision that requires the employee to sell it back to the company at cost if he fails to perform services for a certain period after the stock's acquisition. In that situation, the ordinary income event does not occur until the stock is transferred or the substantial risk of forfeiture lapses, unless the employee makes a "Section 83(b)" election to be taxed at the time the stock is acquired (that is, at the time of option exercise). It is unusual for a corporation to issue restricted stock under an option; if the employer wishes to impose restrictions—to require the employee to remain employed for some period in order to receive a benefit, for example—the vesting restrictions typically are included in the terms of the option, rather

than in the stock that is acquired upon exercise. For example, an option may not become exercisable until the employee has remained employed for a period of, say, three years, but the stock acquired upon exercise is immediately vested.

Tax Consequences to the Issuing Corporation: The employer will be entitled to a compensation deduction at the same time and in the same amount as the compensation income is recognized by the employee. As indicated above, the usual income tax withholding and social security taxes on compensation income will apply, so the company will have the cash flow issue of having to remit those funds to the IRS (and, possibly, to state tax authorities), and will be liable for its share of social security taxes that then apply.

Comparison of ISOs and NSOs

ISO Advantages: The advantage an ISO may have is that for certain employees it will produce two tax benefits: deferral of income (because tax is not paid until the acquired shares are sold, rather than having income at the time of option exercise) and a conversion of ordinary income to capital gain (because any run-up in value between the grant date and the exercise date will be taxed on sale as long-term capital gain if the holding period requirements are met, rather than ordinary income as in the case of an NSO). These potential individual tax advantages may disappear in the case of an employee who will be subject to the AMT on the entire “spread” between exercise price and value at the time of exercise, or one who exercises and then sells so quickly that he has a Disqualifying Disposition. There is also a small advantage in that income arising from ISOs is not subject to social security taxes.

ISO Disadvantages: The principal disadvantage of an ISO is that the company does not receive a compensation deduction for the “spread” between exercise price and value at the date of exercise, as it does in the case of an NSO. If the issuing corporation has a meaningful amount of positive taxable income, the corporate compensation deduction will have a value roughly equivalent to the tax burden on the employee exercising the NSO. (A typical combined federal and state effective corporate tax rate is about 40%.) Accordingly, it is almost always more tax efficient for a taxpaying corporation to issue NSOs rather than ISOs. If it wishes, it should be possible for the corporation to compensate the optionee with additional cash compensation so she is in at least as good a position as if she had received an ISO instead, and the company is significantly better off.

Example: Assume Hi-Tech Corporation is in a 40% combined federal and state tax bracket and Chitra Employee is in a combined 45% bracket and subject to a combined 25% capital gain rate. Further assume she is granted options that, when exercised, have a value \$100,000 in excess of the exercise price.

(a) If the options are ISOs, the federal and state governments will collect a net \$25,000 from the transaction, the eventual capital gain tax on the spread. Unless the AMT applies, this tax will be deferred until the stock is sold. Chitra therefore nets \$75,000. Hi-Tech Corporation does not get any compensation deduction as a result of the ISO grant or Chitra’s exercise.

(b) If the options are NSOs, assume that Hi-Tech Corporation also pays Chitra a \$50,000 bonus because she has foregone the capital gain benefits from ISO treatment.

Chitra's situation is then as follows:

Option spread	\$100,000
Bonus	<u>50,000</u>
Ordinary Income	\$150,000
Tax at 45%	<u>67,500</u>
Net	<u>\$ 82,500</u>

Hi-Tech Corporation's situation is as follows:

Compensation Deduction	<u>\$ 150,000</u>
Tax Savings at 40%	\$ 60,000
Bonus Paid to Chitra	<u>(50,000)</u>
Net Increase in Cash	<u>\$ 10,000</u>

Thus, both Chitra and Hi-Tech Corporation can be better off with the NSO alternative.

Accounting Treatment: Because the difference between ISOs and NSOs is purely a tax concept, there is no particular difference in the accounting treatment of the two types of options. Unless the employer has elected otherwise under FAS 123, there is normally no charge to earnings at any time in the case of an option that was granted with an exercise price at least equal to fair market value at the time of grant and with vesting based on continued employment (rather than on meeting performance goals). However, footnote disclosure is now required estimating the value of all stock options. There may also be an earnings charge if the employer regularly repurchases stock within six months of its having been acquired by option exercise.

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Inasmuch as an NSO gives rise to a corporate compensation deduction at the time of exercise, NSOs may have an indirect tendency to increase book income because the tax deduction for compensation may reduce the taxes currently payable by the company.

OFFERS, SALES, AND REALES OF STOCK AND OTHER SECURITIES

Fund raising can seem, at times, to be an all-consuming activity for an entrepreneur. In the face of frantic activity, however, it is important to remember that complex state and federal rules govern all securities offers and sales – even those to family, friends, and employees. The discussion below explains certain aspects of securities law to help you identify issues and seek appropriate legal advice before it is too late.

All Offers and Sales Subject to Regulations

All offers and sales of securities, whether by a company (an “issuer”) or by a security holder, must be registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 and various state securities or “blue sky” laws, unless there is an exemption from registration. Failure to comply with these requirements could result in a right on the part of the buyer to demand his or her money back at any time, and in

personal civil and criminal liability (as well as injunctive sanctions) to the offeror or seller. In the case of corporate offers and sales, that liability can extend to officers, directors, and major stockholders. Common stock, preferred stock, warrants, options, limited partnership interests, limited liability company membership interests, debentures, bonds and notes, and other business interests can all constitute “securities.”

Registration

Initial registration, more popularly known as “going public,” is an expensive and lengthy process that involves the preparation of a registration statement (of which a so-called prospectus is a part) describing the company, its business, management and prospects, the securities offered, and various other matters and containing audited financial statements. Typically, underwriters become heavily involved in marketing securities sold by the company under a prospectus. The registration statement is filed with the SEC and the National Association of Securities Dealers (NASD) for review and comment. After revision of the registration statement in accordance with the comments of the SEC and after it is declared by the SEC to be “effective,” the company (and/or the selling security holders, if any) will be permitted to offer and sell the securities covered by the registration statement to the general public. Thereafter, following a related registration process under the Securities and Exchange Act of 1934 (“the Exchange Act”), the company will be obligated to make regular quarterly, annual, and other disclosures and filings with the SEC. Certain disclosure requirements also apply to insiders of the company (such as directors and executive officers). The process may result in a public trading market for the company’s securities which, depending on its depth and breadth, may provide a degree of liquidity for security holders.

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Certain Exemptions

In the absence of registration (*i.e.*, before a company has gone public, or afterwards if not all of the company’s shares were registered in the initial offering), an offer or sale may be made only if there is an applicable exemption. The principal exemption that may be available is the “private placement” exemption.

Private Placements: Essentially a private placement is the offer or sale of securities by the issuer to a small number of sophisticated and knowledgeable investors who have been solicited in a limited offering process. Federal law provides several safe harbors, called Regulation D, for certain private placements. The principal requirements of the most common private placement, called a “Rule 506” offering under Regulation D, are:

- if offers are made to anyone who is not an “accredited investor,” then certain information equivalent to that included in a registration statement for a registered offering must be provided to all prospective investors;
- there must be no more than 35 investors who are not accredited investors in an offering (subject to integration, as noted below); and
- general solicitation or advertising may not be made in connection with an offering.

“Cold calling” or mailing of materials to persons with whom there is no pre-existing relationship will violate the prohibition against general solicitation.

An unlimited number of accredited investors is permitted under a Rule 506 offering. Accredited investors include institutional investors with at least \$5 million of assets and persons with certain levels of income (in excess of \$200,000 for an individual and \$300,000 in joint income per year) or significant net worth (in excess of \$1,000,000). Under a principle called integration, the number of unaccredited investors who participate in any of the company’s offerings six months prior to, and six months after, an offering count toward the 35 unaccredited investor limit in the present offering. Of course, even in the case of offers or sales to accredited investors, full disclosure with respect to the company and its business must be made. State blue sky laws have largely been preempted with regard to Rule 506 offerings. Therefore, states can only require a copy of the Form D that is required to be filed with the SEC, a copy of the offering document, the filing of a consent to service of process in such state, and various filing fees.

Rule 701 Sales: Rule 701 provides a special exemption from federal registration requirements for offers or sales of securities by non-reporting companies (*i.e.*, before a company has gone public) for the purpose of compensation (and not for the purpose of raising capital), pursuant to a written compensation plan or contract to employees, directors, general partners, trustees, officers, and certain consultants or advisors. The amount of securities that may be sold in a twelve-month period, cannot exceed the greatest of \$1,000,000, 15% of the company’s total assets, or 15% of the outstanding securities of the class being offered. Options are counted as sales on the date of the option grant. If more than \$5,000,000 worth of securities are to be sold, the company must provide disclosure to all of the purchasers. Securities sold under Rule 701 are considered “restricted securities,” but 90 days after a company becomes a reporting company, securities issued under Rule 701 may be sold by non-affiliates without regard to the Rule 144 conditions discussed below, except for the “manner of sale” requirements. After a company goes public, affiliates are still subject to all of the Rule 144 conditions for Rule 701 stock, except for the holding period. Filings may be required by state commissions in connection with these offerings. Many states, including Massachusetts, have a parallel exemption to Rule 701.

Blue Sky Matters

State “blue sky” securities laws apply, in addition to the federal rules described above, and they vary considerably from state to state. The National Securities Markets Improvement Act of 1996 preempted state blue sky laws with respect to “covered securities” registered with the SEC and Rule 506 offerings from state registration, but notice filings and broker-dealer restrictions still apply. Failure to comply with these laws can result in considerable liability both for the company and its officers, directors, and controlling stockholders. Therefore, it is essential to obtain current legal advice before making any offers to sell securities.

Resales of Restricted Securities

Restricted securities are securities that are acquired in a transaction other than in a

registered offering or in the public markets, even if the company is or subsequently becomes public. Rule 144 provides a safe harbor exemption from the registration requirements of federal law for certain resales of restricted securities. The company must be public and must be current in all reporting obligations. The securities must have been held by the seller for at least one year and sales by a single person (or such person's affiliates, in certain cases) are limited by certain volume restrictions, typically based on the greater of average weekly trading volume or 1% of the company's outstanding shares in any three-month period, and must be sold through a broker. A notice of sale must be filed with the SEC. If the securities have been held by a non-affiliate for two years, the Rule 144 restrictions no longer apply. Rule 144 has a number of other requirements concerning the "manner of sale" or the kind of transaction in which the securities may be sold and when sales by another person (such as a spouse) are aggregated with the proposed sale to determine if the volume restrictions have been exceeded. In the case of corporate insiders or other controlling persons (referred to as "affiliates"), even shares that are not restricted are subject to some of the same restrictions as restricted securities. Rule 144 is highly technical, and a lawyer versed in the area should be consulted in advance of relying on the rule.

Resales of Publicly Traded Securities

Securities that have been the subject of a registration statement are, generally, freely transferable thereafter. However, stock held by persons who are deemed to be "affiliates" of a company, as explained above, are still subject to restriction on sale.

Rule 10b-5 and Common Law Fraud Liability

Full disclosure is required in connection with almost all securities offerings. If the offeror or seller misleads the buyer by misstatement or omission in a material manner in connection with the offer or sale of a security, such person can incur significant liability under Rule 10b-5 of the Exchange Act, under State laws, and under common law fraud principles, including treble damages and other sanctions. These issues will be determined with the benefit of hindsight, so even misstatements or omissions that may not have seemed important or significant when made can later prove to be disastrous.

MANAGING EXPLOSIVE GROWTH IN TECHNOLOGY COMPANIES



Managing Explosive Growth in Technology Companies

By Barry Glick*

Explosive growth can be your company's best friend—or its worst enemy. Almost all business owners dream of such growth, and while it is certainly exhilarating, it can also be inconvenient and unmanageable. During periods of exponential growth, it seems that there's never enough time or resources to implement procedures or hire adequate staff. Ironically, growing too fast can even jeopardize the future of the company. Blind expansion and adopting a "We'll cross that bridge when we come to it" attitude can cost you sales, frustrate your employees and lock you out of opportunities for future growth. Instead of plunging ahead, you need to anticipate problems and make tough decisions about how to best meet your company's and your customers' needs.

Growth is a daunting challenge. It is hard to achieve and even harder to sustain. Only one company in six can sustain a top tier growth record longer than a decade. And, once a company falters, only one in three can rebound in the ensuing five years.

So, how do the lucky few manage to surmount the challenge? First, they implement a robust architecture to scale business rapidly. Building mass and focusing energy are the core tasks that contribute to a company's momentum at this stage of its life cycle. The critical questions to ask at this stage are:

- Do you have the leadership needed to manage the success of rapid growth?
- Are you protecting your brand from competition?
- Can you sustain management and alignment during growth and chaos?
- Can you attract and integrate new talent with Internet speed?

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After ensuring an affirmative answer to the above questions, successful companies will create a growth vision of how they will manage their increased scale. Rapid growth can create unfocused confusion for employees. As a result, you need to provide direction and re-focusing as the company's needs change and enable collaborative innovative work without duplication. The only way to be assured of these goals is through consistent monitoring. As a manager, it is important to adopt a "hands on" approach to growth regarding such diverse topics as human resources, internal infrastructure, and customer/strategic partner relationships.

Growth Vision

Young companies need to envision themselves as much larger enterprises almost immediately. Since maintaining momentum through periods of rapid growth requires you to frequently "re-purpose" your organization, this vision must be stated as a growth system to be designed and redesigned. Business models, product strategies, and target

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markets all can become extinct overnight. A core challenge, therefore, is maintaining your company's alignment with market dynamics. To do so, commitment, strategy and capability are three cornerstones that must be incorporated into a company's growth vision.

A commitment to grow is a fairly obvious component of sustainability, and, typically, early stage entrepreneurs have a laser focus on this cornerstone. However, it is nonetheless important to periodically monitor whether or not you are allocating sufficient effort and resources to the task. Rapid growth often means a company has outgrown its initial systems and strategies. Maintaining endurance and magnetism requires cutting-edge systems and employees who are committed to growth of the company.

An effective strategy is similarly critical for growing your company. Strategic planning provides the platform for long-term success by carefully mapping out future growth and planning in advance for obstacles that may be encountered along the way. A strategy of this nature is also helpful in re-focusing and providing direction to employees.

As the third cornerstone, capability allows an organization to sustain its growth as hot products fade and leadership teams retire. Central to a company's early success is a hot product or service coupled with a strategic formula for staying ahead of the competition. Young companies can ride this early momentum for a while, but eventually their lack of a growth infrastructure—capability—will bring their success to a halt. Ultimately, capability provides an enterprise with the ability to redefine itself to sustain value-generating growth. As a company gains scale, it must round out all three elements of its growth vision.

Emerging Growth Companies

A critical problem, surprisingly, is too much success too soon. When a company comes out of the starting blocks like a rocket, its leaders tend to get seduced by their success. They believe they have invented a growth engine that will go on *ad infinitum*. A better solution, of course, is to build a vision of a larger scale future and work to create the changes needed to get there.

Successful companies navigate this phase by learning from others and by setting up indicators, metrics that signal a trend or dangerous pattern. One key indicator is the rate of growth of revenues versus the rate of growth of employees. In top performing companies, revenues grow an average 15%-25% faster than headcount. Much above this range, and the hiring, training and culture-building challenge is too great. At accelerated growth rates, the tendency is to hire bodies, not talented people with long-term potential. Operating too far below this range signals productivity problems and inefficiency.

Building a Team

When you build a team, you need to build a whole company as early as possible. People who start off with a flat organization often get to the point when they are about 35 or 40 employees strong, that all of a sudden some kind of management hierarchy becomes necessary. The problem they are now faced with is taking someone out of a peer group

and making that person someone's manager. This task can be fraught with problems. A hierarchical structure in the beginning is a necessity in order to avoid these traumatic transitions during vulnerable growth stages.

The cardinal rule of building a successful hierarchy has been dubbed the "one throat to choke" model. When you build a hierarchy, do it such that the accountability for a given sub-organization ultimately ends up at one person's desk. This way, at the end of the day, one person is responsible and your managers cannot point fingers at other departments.

Additionally, it is often helpful to separate the organizational hierarchy from the communication hierarchy. The reporting structure must be vertically scalable to allow for upward growth. On the other hand, the communications structure must be flat so that information flows quickly to where it can be acted upon with the most impact. Key to success is an open-door policy and a secure, strong middle management that is not threatened by upper-level management talking directly to all levels of employees.

Coming of Age

The seminal problem that stage two companies encounter is misjudging the transition from manageable size to the complexity of a tenfold increase in size. Scale changes everything. Specifically, two issues most often confront the leaders of these companies. First, processes designed for simpler times cannot handle the increased workload. Companies that maintain their head of steam understand which processes are critical to revenue growth and constantly test them and redesign them as necessary.

The second issue is losing touch with key constituencies, that is, customers and employees. Losing touch with customers leads to valuable formulas that get tired and lose their value. Losing touch with employees is equally problematic. Highly energized employees are a leading indicator of continued growth. The successful companies work hard at gauging employee and customer satisfaction. They redesign processes and set up metrics to uncover problems they used to see first hand during the simpler life of a stage one company. And they invest heavily in information technology to help stay in touch.

Economics of Growth

Sustaining value-creating growth requires heavy investment. In addition to the high rate of spending on IT, aggressively growing companies also tend to outspend others in research and development, marketing and forging alliances. It is important to recognize that this rapid growth chews up significant working capital. Do not assume that once your company becomes profitable, you can automatically afford future growth without planning ahead. Many young companies expand beyond their working capital resources and get caught needing to borrow or raise new equity money at inopportune times. This situation can lead to management headaches, since you are left to frantically ensure that spending does not outpace your fund raising efforts. Successful companies, with their visionary growth systems in place, make their investments of both time and capital highly productive by analyzing company needs in detail prior to expansion.

Scalability

Scaling corporate operations is the much-misunderstood aspect of any company. Operations does not simply mean manufacturing; it incorporates anything and everything that your customers could get upset about-support, quality of products, timeliness of shipping, and so on. Today, there are numerous effective back-office automation tools that can become the crux and foundation of a business. If you build the right automation back-office systems, a company can scale incredibly well with fewer people, and without those people burning out.

Moreover, the ability to form and manage alliances is a key strategy for companies of all sizes and in all sectors. The role of scale varies by sector. In the technology and consumer sectors, large markets exist with numerous high growth niches. Thus, these are fertile grounds for new companies to start in. Small technology companies with a strong valuable formula are able to achieve high organic growth, yet also seek to grow by acquiring related or complementary new technologies. This horizontal growth strategy through acquisition provides a solid footing as revenues top U.S.\$1 billion. As these companies grow further, they add scale to their businesses, fuelling another round of acquisition activity in the mid-revenue category.

Clearly, growing a scalable organization can prove to be extremely profitable, if done carefully. Get the basics right, stay focused, out-execute your competition, and you stand a good chance at succeeding in today's ever evolving global economy.

CHOOSING AN EXIT STRATEGY



Choosing an Exit Strategy

By Nat Kannan*

Perhaps the most important piece of the initial business plan that is commonly overlooked by entrepreneurs is their exit strategy. It probably seems strange to spend much time thinking about how to liquidate your future interest in a business that doesn't yet exist. Yet, your exit strategy impacts many directions that you might choose in growing your business. Not considering your exit strategy early may indeed limit your options in the future. Remember: it is not a matter of *if* you will sell, or otherwise dispose of, your interest in this business. Your only decisions are when and how.

Which strategy will serve the growth and profitability of the business and bring its founders the financial rewards they seek? Taking a budding business public through an initial offering of stock isn't always the best wealth creation strategy or always right for your business. Often the perceived benefits of going public are realized, but the path to being a public company involves a great deal of old fashioned planning, plenty of hard work, and, in many cases, a bit of luck.

Aside from taking the company public, entrepreneurs can also choose to sell the company. By opting to sell, these owners have liquidated their holdings and are now free to pursue other business possibilities, something that may be appealing to true entrepreneurs. Each option represents a tradeoff between the "big bang" of quick money and the flow of cash over time to reinvest in business growth – a balance of short- and long-term interests. And each represents choices about solo control of the business weighed against the involvement of partners and shareholders.

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Whichever path you choose, it is important to keep in mind that a successful entrepreneur has a vision of growth for the company and guides it accordingly. This means that you must decide early on what the end goal is for your enterprise. Are you growing your business for the long run? Do you want a viable corporation that will last for generations? If the answers to these questions are "yes," then you may very well want to consider an IPO. If, on the other hand, your goal is quicker liquidity and you don't care as much about your business' longevity, you may want to shoot for an acquisition. Should you fail to decide which of these paths to guide your company down, you are likely to be setting mixed agendas, or worse, no agenda at all. An unguided and unfocused business is likely to fail or, at best, limp along until ultimately you are left without much of a choice in the way of an exit strategy. Furthermore, if an unforeseen event causes your enterprise to enter into a crisis situation and you do not have an exit strategy in place, one may be forced upon you, and often the terms will be less than favorable.

Another factor you must consider in weighing your choices for an exit strategy is where your company's funding is coming from. If you are trying to build a large global

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enterprise, or even start a smaller corporation in today's fast paced technology markets, you may decide to tap the private or public capital markets. In this case, you add a new dimension to your role as an entrepreneur-you become a custodian of your investors' money and you now must consider their long-term financial objectives, as well as your own. Given the current uncertainty of the public market, investors may be more hesitant to pursue an IPO and may prefer an acquisition as a faster path to profitability.

Going Public

IPOs involve the issuance of new shares for cash, at a time when the business is challenged with an opportunity to grow, which would be facilitated with an infusion of cash. However, going public generally limits your exit options and, by default, defines your exit strategy. Selling ownership to public markets generally provides the cash for growth, while offering the principals of the company the promise of some future liquidity of their shares. Liquidation by the entrepreneur can be accomplished, but it is likely to require many years due to strict SEC regulations and the company's own guidelines that limit the opportunities for an entrepreneur to liquidate. Additionally, when you can liquidate the value of your stock is tied to the fluctuation in the public markets.

Due to these facts, the decision for a company to go public is often difficult, and the pros and cons of this move need to be seriously considered. An obvious advantage of going public is that a company gains considerable proceeds and much greater access to additional capital from the public market. Also, public companies are in a better position to recruit and retain employees; equity plans such as employee stock purchase plans and stock option plans promote employee loyalty and productivity. Add to these greater visibility and recognition, and IPOs may seem like the way to go. However, companies also need to consider numerous other factors before making the final decision to go public.

One of these considerations is that the general threshold for a successful IPO is a market capitalization of at least \$250,000,000. Below this number, the mutual funds and the market analysts are not interested and the stock doesn't have the support to sustain the value in the market. A second consideration is that start-up companies must demonstrate the potential to develop into profitable enterprises that will deliver significant annual increases in sales and earnings. The minimum earnings growth potential is 20 percent per year, and the company should be able to achieve a valuation of at least \$100 million to be truly successful as a publicly held corporation.

Additionally, management must also be willing to incur significant costs in the initial public offering process itself, as well as ongoing costs to interact with shareholders. In fact, the up front costs to go public typically fall in the \$400,000 to \$700,000 range. Coupled with this outlay of money, the process is also extremely time consuming and stressful for the management over an extended period of time. And, once public, the management may remain distracted for a time as they shift the focus of their efforts toward the market's expectations, meaning they must devote a new level of attention to quarterly earnings and revenue projections. A distracted management can be disastrous for any company, especially a relatively young one.

Another sizable consideration is the increased liability a company and its officers face as a result of fiduciary obligations and the threat of stockholder litigation, not to mention the scrutiny by securities analysts and stockholders, and the constant pressure to achieve and exceed public expectations. Going public also means being in the public eye. Securities and Exchange Commission reporting requirements guarantee that public companies lose their ability to keep certain aspects of business confidential. Furthermore, when a company goes public, the CEO is fully exposed and must live in the spotlight, explaining disappointments as well as achievements to a vast audience that tends to be highly critical of the company and its leadership. Clearly the company is now subject to the whims and fluctuations of the market as a whole.

Overall, the IPO is a glamorous move – and a tricky one. Everything from choosing the investment banking firm you use to getting the timing right and setting the stock price involves calculated risk. While the odds may be better than at the slot machines in Vegas, be assured most companies are not an overnight success. On the upside, you have tapped into a huge new source of funding to fuel the business, not only now, but also in the long term. If you do it right, you also receive important recognition for the business and ongoing attention and publicity associated with the stock price.

Public companies have significantly higher valuations than private companies. This is primarily because of the liquidity of public stock. Call your stockbroker and it is sold! In selling a private company, call your intermediary and hope it sells within a year. Shannon Pratt, founder of Willamette Management Associates, one of the oldest and largest independent valuation consultants, states in his recent book, *Cost of Capital*, that discounts for lack of liquidity (marketability) are often in the range of 10 to 50%.

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The bottom line: if your company has the potential market capitalization of \$250,000,000 and you have the stomach for the fishbowl of the public arena, go public. If not, plan a private sale.

Selling the Business

From the standpoint of the founders of a company, acquisitions are much easier than IPOs. They are a nice way to ease into retirement, or to move onto another project. Selling your company at a time of solid growth and profitability can be the most concrete way to reap the value of your hard work and risk-taking as a founder. There's money in the bank, and the satisfaction of passing the enterprise on to a new owner who can take it to the next stage of its growth while you get on to other projects. However, selling your business to another individual or independent business is a huge decision and generally one that is difficult to make. One day you own the business, and the next day you do not. To optimize the terms of the sale, the new owner will insist you continue to operate the business for an agreed-upon period of time. From another perspective, then, you move from controlling owner to employee in one quick step.

The proceeds from the sale of a private company are usually for cash, for shares of a public company, for shares of a private company, or for a combination of the above. This

is generally a move toward greater liquidity in your personal estate. You are selling illiquid shares of your private company for cash and/or shares of a public company that will eventually become liquid.

This allows the successful entrepreneur, who often has nearly 100 percent of his or her assets tied up in the business, the option of diversifying his or her portfolio of investments. Some entrepreneurs sell to other private companies and achieve asset diversification by becoming part of the larger, merged business. While immediate liquidation may not be their primary driver, entrepreneurs who take this course usually move closer to a liquidation opportunity.

Perhaps you are more interested in the launch than in running an established business, or you simply need to cash out for other reasons. The downside is, whether or not you sign on to stay with the company, you have once and for all lost your position at the helm of the ship. You have sold your "baby." You are no longer in control. You may have passed up the opportunity to grow the business, as well as the value of your shares, in the future.

When do you sell? Perhaps a good time to start thinking about the possibility is when you are losing sleep (or your hair) because you realize the following:

- Your business is a very valuable asset;
- Ownership represents nearly 100 percent of your net worth; and
- Some power outside your control could take that away from you.

Choosing a winner

Neither the IPO nor the acquisition is a “lesser” option. A popular myth is that an IPO is the winning strategy with mergers and acquisitions being runners-up. On the other hand, cynics of the IPO may believe that a company opts to go public either because it expects to reap little profit, making it cheaper to have shareholders than to owe fixed interest payments, or because it simply can’t get funding from traditional lenders, meaning that it’s in a high-risk business. If either is the case, as is true for many IPOs, you should avoid jumping on the IPO bandwagon at all costs.

Every entrepreneur needs to take a cold, hard, clear-headed look at which exit strategy best fits the situation. For example, if the company is relatively freestanding (i.e., operationally independent of its suppliers and customers, for the most part) and looking to expand exponentially, then an IPO may be a good option at the right time. But if business operations depend heavily on close collaboration with a few key suppliers, then a merger or acquisition might gain you important ground in the efficiency of vertical integration.

Manage your business every day for optimum growth and profitability. Focus on building a strong company with high-quality products and services, and a successful organization. Hire a team of outside professionals, such as an investment banker, an experienced lawyer and a CPA who will work together to help you maximize your

rewards. In time, the right strategy will reveal itself to you. Attractive suitors may line up to buy the company, or firms may beg to take it public for you. If you are building a great company, and linking yourself with worthy partners, then all of your exit options will be positive ones.