

Preparing for Venture Capital

Grant Thornton LLP

Tony Ricciardella

Assurance Partner

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Preparing for Venture Capital

Corporate Structure

S-Corporation

- Advantageous from a tax perspective since profit and losses pass through to the shareholders
- Avoids double taxation in the event of a sale of the Company.
- Not very flexible when try to raise capital
 - Limited number of shareholders (75)
 - Limited to one class of stock
 - VC's investment would probably bust the S-Corp election

Preparing Venture Capital

- Corporate Structure- continued
- Limited Liability Corporation
 - Has the benefits of a partnership and a Corporation. Can make the election (check the box) to be taxed as a C-Corp.
 - Permits more than one class of stock and more than 75 shareholders.

C-Corporation

- Permits more than one class of stock and more than 75 shareholders.

Preparing for Venture Capital

- Accounting Matters
- Accounting System and Reporting
 - Should have an accounting package and manpower to process transactions timely.
 - Establish a relationship with an outside consultant or have a part-time controller assist with monthly accounting and financial reporting.
 - Be proactive with respect to financial reporting. Although you may not need an audit, you should consider getting a compilation or review on an annual basis.
 - Even if not audited, discuss your business model and revenue recognition practices with your outside accountants.

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- Accounting Matters
- Revenue recognition
 - Area under continuous scrutiny for technology companies, particularly software companies.
 - Revenue should be recognized when all of the following are met:
 - Persuasive evidence of an arrangement exists
 - Delivery has occurred
 - The vendor's fee is fixed and determinable
 - Collectibility is probable
 - Number of issues surround multiple element arrangements, particularly future commitments and support (i.e. delivery of license agreement and post contract customer support)
 - Emphasis on Vendor Specific Object Evidence (VSOE) of fair value for all goods and services being delivered.
 - Finally focus on the substance of the transaction, not just the form. Have you really “earned” the revenue?

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- Research and Development Costs
 - Generally expensed as incurred
 - Certain software development costs qualify for capitalization once technological feasibility has been established.
 - Capitalized costs should be supported by contemporaneous records (i.e. timesheets for employees working on development activities or consultant invoices)
 - Costs should be captured separately for each development activity
 - Capitalized costs should be amortized over the estimated economic life on the basis of actual to projected sales or on a straight-line basis
 - Such costs should also be measured for impairment
 - Common practice to be conservative and expense up front rather than impact future profits.

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- Stock Compensation and Other Related Issues
- Accounting for options granted to employees is currently under review by the Financial Accounting Standards Board (FASB).
- The FASB is leaning toward “fair value” method of accounting for all option grants. This methodology requires the use of an option pricing model, and most often gives rise to compensation expense.
- This methodology is somewhat difficult for privately-held companies to implement because it requires an estimate of the fair market value of the company’s common stock. Management should generally look to equity transactions that occur during the year as an indication of fair market value.

Preparing for Venture Capital

- Stock Compensation and Other Related Issues
 - Equity Issued in Exchange for Services
 - Used as “currency” when cash is in short supply.
 - Measurement for purposes of recording such transactions should be based upon the fair market value of the consideration exchanged, which ever is more readily determinable.
 - When exchanging options or warrants for services, the fair value method is required to be used.

Receiving Venture Capital

- Funding from the venture capitalist may come in the form of debt or equity financing or some combination of both (i.e. debt with warrants).
- Need to ensure that all consideration exchanged is properly recorded (for example, in a debt with detachable warrants transaction, the value of the warrants would be recorded as a contribution to equity and a discount to the face amount of the debt).
- Beware of beneficial conversion features in convertible equity or debt instruments.

Receiving Venture Capital

- Other Matters
 - After the investment you will have a new member(s) on the board.
 - Will probably be required to have an audit performed annually by a reputable accounting firm.
 - Will likely have an audit committee that will meet periodically throughout the year to discuss accounting and auditing matters.

Grant Thornton Can Help

- Grant Thornton is the 5 largest accounting firm nationally and globally
- Emphasis is on middle market companies
- Several partners in the Washington Metro Area than are available to assist your company.
- Rich LaFleur- Washington Metro Area Managing Partner
- Cal Hackeman- National Director-Technology Industry Practice
- Perry Sandler- Tax Partner, Vienna, VA
- Jim Stanker- Assurance Partner, Baltimore, MD
- Kerry Hall- Assurance Partner, Vienna, VA
- Tony Ricciardella- Assurance Partner, Vienna, VA