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Raise capital, not red flags

The survival rate for start-ups is understandably low and without adequate funding even the strongest business ideas won’t survive. Entrepreneurs looking to grow their ideas into billion-dollar businesses will, in most cases, need substantial funding to get their operations up and running. With a multitude of options available, selecting the right type of funding can often be confusing and/or overwhelming. Any funding raised will be reflected in the company’s financial statements and therefore open to scrutiny. So before signing on the dotted-line, you should know how your financial statements will be affected.

This article highlights some of the main features you need to look out for, from an accounting perspective, when raising seed capital and how your financial statements could be affected.

What is seed or foundation capital?

Seed capital is money raised in the early years of the business when operating and investing cash flows are constrained and sustainable cash inflows haven’t yet been established. To this end, seed capital typically doesn’t require any payments - such as interest - to be paid to the investor until an exit event (eg. an IPO) or cash profitability is reached.

One way to look at seed capital is from the perspective of the start-up that needs the money and the investor that provides the money, as reflected in Table 1.

<table>
<thead>
<tr>
<th>What the start-up wants</th>
<th>What the investor wants</th>
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<tbody>
<tr>
<td>Cash to fund operations, R&amp;D and capex until an exit event or sustainable minimum number of customers is reached</td>
<td>Extraordinary returns through an exit event, not ordinary principal and interest</td>
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<tr>
<td>Flexible funding as they have no ability to pay coupons or principal back in the initial phase, and traditional bank financing isn’t viable</td>
<td>Investment terms that are carefully tailored to manage individual investee attributes, risks and circumstances</td>
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<tr>
<td>Partners in growth - investors who bring expertise, networks and connections in addition to funding</td>
<td>Opportunity to provide other services, which may be paid for through warrants and options</td>
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What else do investors want?

Investing in start-ups carries a high risk. The start-ups themselves lack liquidity, their founders want to minimise dilution of ownership and it's difficult to value the business. Consequently, directly investing in a start-up's ordinary shares isn't always appealing or viable. Whatever form the funding takes, though, investors will have an exit strategy to maximise returns where businesses take off, or limit exposure to losses where the start-up fails to become profitable.

For instance, to maximise investor returns seed capital is usually in a form that provides flexibility for the investors to take on interests in the investees down the road at a discount, such as warrants, options or mandatory conversion features. Additional terms are usually included to safeguard the investor's capital; for example, mandatory redemption features or non-discretionary interest payable on maturity. These are typically either date-limited or linked to cash flow milestones. The legal form may be notes or preferred shares.

Hybrid funding may also be employed for intermediate stage businesses that are generating some positive cash flows. These structures combine fixed interest and equity type returns for investors with appetite for higher risk investments.

What should start-ups look out for?

Because of an eagerness to map out business plans and the lack of cash on hand, it's easy for start-ups to focus more on the commercial feasibility of funding agreements, while overlooking the potential accounting issues. Start-ups should consider all of the terms and conditions of any funding agreement since a single clause can greatly affect the accounting treatment (ie. how any capital raised should be treated in accordance with accounting standards). Such treatments will likely face scrutiny from a broader investor group if the start-up launches an IPO down the track since all early rounds of funding would be reflected in the IPO financial statements.

What are the accounting implications?

Seed, and indeed all, capital is classified as either debt or equity. Accounting equity is simple to administer as it is never remeasured in your balance sheet. But it is very hard to achieve in practice for seed capital. Accounting debt is the default alternative. Debt may be simply measured at amortised cost if all that exists are interest payments and repayment at maturity. Any other feature, such as conversion to shares, early repayment options or repayment based on a milestone (eg. achieving an IPO) is likely to require measurement at fair value through profit and loss.

Two complications then arise:

- fair value is measured and remeasured at each balance date - this means startups must build a complex model or incur expenses for a service provider, and
- fair value is measured by reference to the future potential of the business - as the business grows and becomes more successful, the liability on its balance sheet will increase. In effect, the business must book an accounting expense for success and growth.

Table 2 lists the accounting issues that can arise from common features of seed capital.
### Table 2. Accounting issues arising from common features of seed capital

<table>
<thead>
<tr>
<th>Issue</th>
<th>Accounting treatment and impact</th>
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<tbody>
<tr>
<td><strong>Contingent events</strong></td>
<td>Certain clauses may be triggered by the occurrence or non-occurrence of certain events (e.g., an IPO). The reason for these clauses may be to motivate the company to reach certain outcomes and give non-controlling investors a viable exit strategy. Investors typically don’t expect repayment of capital in absence of the event because the start-ups are unlikely to have sufficient financial resources at that stage. Any repayment clause that is not solely within the control of the issuer is likely to trigger debt classification. This applies to coupons and principal. Common such clauses include maturity if an IPO event doesn’t happen within 3 years or repayment once revenue reaches a certain level or breakeven cash flow is achieved. Debt classification is very common. However, directors should be mindful of solvency if trigger clauses allow investors to demand immediate repayment when milestones are not reached.</td>
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<tr>
<td><strong>Dilution protection clauses</strong></td>
<td>Seed funding may involve multiple rounds. Typically, investors will require various anti-dilution and seniority clauses to protect their interests. Dilution clauses are common to protect investor interests. They can force characterisation as accounting debt or even the recognition of a separate derivative at fair value through profit and loss. This arises as they may require coupon payments or issuance of further shares if certain events happen.</td>
</tr>
<tr>
<td><strong>Conversion features</strong></td>
<td>In order to acquire interest in the investees at a discount, conversion features (or other derivatives) are usually embedded in the financial instrument. These are extremely common, particularly when the investor is seeking exposure to participate in an IPO or other exit event. A cap, floor or collar could also be included in the agreement when the conversion entitles the investor to a variable number of shares. A conversion feature can be embedded in a host instrument, such as a debt (e.g., convertible debt) or preferred stock (e.g., convertible preferred stock). Usually, these will lead to either debt classification or the recognition of a separate conversion derivative at fair value. The only limited exemption to debt or derivative classification is if the conversion feature allows for conversion of a fixed dollar amount into a fixed number of shares. Any variation - for example, if the dollar value is set in a foreign currency - will fail equity classification.</td>
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What you need to do before finalising the financing agreement

As Table 2 shows, the accounting treatment for funding arrangements can be complex. If you're planning to raise seed capital, it's important to:

1. understand the accounting consequences of each term in your arrangement
2. understand the cost of ongoing compliance, particularly where valuations may require external expertise, and
3. agree the accounting treatment and any basis of valuation upfront with your auditor and secure access to a valuation model.

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