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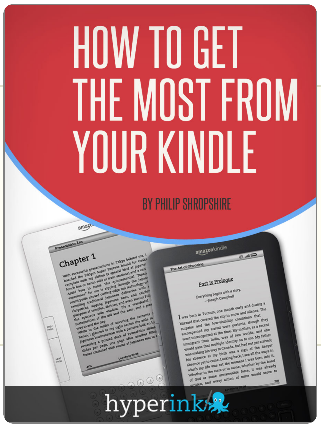

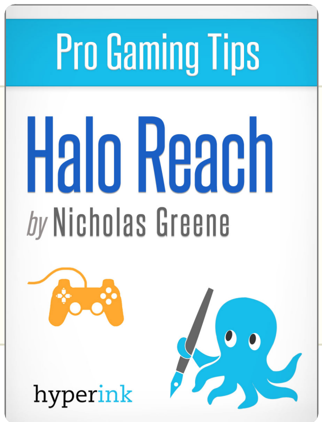

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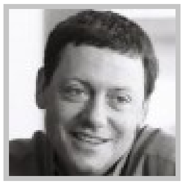


Fred Wilson

I am a VC. I have been since 1986. I help people start and build technology companies. I do it in NYC, which isn't the easiest place to build technology companies, but it's getting better.

I love my work. I am the Managing Partner of two venture capital firms, Flatiron Partners and Union Square Ventures.

I also am a husband and a father of 3 kids. I do that in NYC too. And it isn't the easiest place to raise a family either. But it's getting better too. I love my family more than my work.

I also love music, art, yoga, biking, skiing, and golf. That's a lot of interests for a guy who works 70 hours a week and loves his family. But I manage to make it work.

Check out my full blog at: www.avc.com

Book edited by Jason Karpf.

Get in touch:

I.

Chapter 1: "Who Is" Your Company?

Corporate Entities

When you start a business, it is important to recognize that it will eventually be something entirely different than you.

Incorporation

First off, you don't have to incorporate to be in business. There are many people who run a business and don't incorporate, such as numerous sellers on Etsy (http://www.etsy.com/). They make things, sell them, receive the income, and pay the taxes as part of their personal returns.

But there are three big reasons you'll want to consider incorporating:

- Liability
- Taxes
- Investment

And the kind of corporate entity you create depends on where you want to come out on all three of those factors.

I am not a lawyer or a tax advisor so if you are planning on incorporating, I would recommend consulting both before making any decisions. Note that this chapter is entirely based on U.S. law and does not attempt to discuss international law.

The Big 3: Avoiding Liability, Protecting Profits, Creating Partnerships

When you start a business, it is important to recognize that it will eventually be something entirely different than you. You won't own all of it. You won't want to be liable for everything that the company does. And you won't want to pay taxes on its profits.

Creating a company is implicitly recognizing those things. It is putting a buffer between you and the business in some important ways.

When you create a company, you can limit your liability for actions of the corporation. Those actions can be for things like bills (called accounts payable in accounting parlance), promises made (like services to be rendered), and lawsuits. This is an incredibly important concept and the reason that most lawyers advise their clients to incorporate as soon as possible. You don't want to put yourself and your family at personal risk for the activities you undertake in your business. It's not prudent or expected in our society.

Taxes are the next thing most people think about when incorporating. There are two basic kinds of corporate entities for taxes:

- Flow-through entities
- Taxpaying entities

Flow-through corporate entities don't pay taxes; they pass the income (and tax paying obligation) through to the owners of the business. Taxpaying entities pay the taxes at the corporate level and the owners have no obligation for the taxes owed.

Your neighborhood restaurant is probably a flow-through entity. Google is a taxpaying entity. When you buy 100 shares of Google (https://www.google.com/), you are not going to get a tax bill for your share of their earnings at the end of the year.

If you want more information on corporations and taxes, go to the source–the IRS: http://www.irs.gov/businesses/corporations/index.html

And then there is investment/ownership. Even before we talk about investment, there is the issue of business partners. Let's say you want to split the ownership of your business 50/50 with someone else. You have to incorporate to create the entity that you can co-own. And when you want to take investment, you'll need to have a corporate entity that can issue shares or membership interests in return for the capital that others invest in your business.

Common Types Of Corporate Entities

LLC

For many new startups, the form of corporate entity they choose is called the LLC. It stands for Limited Liability Company. This form of business has been around for a long time in some countries but became recognized and popular in the US sometime in the past 25 years.

The key distinguishing characteristics of a LLC is that you get the limitation of liability of a corporation, you can take investment capital (with restrictions that we'll talk about next), but the taxes are "flow through". Most companies, including tech startups, start out as LLCs these days. Owners in LLC are most commonly called "members" and investments or ownership splits are structured in "membership interests."

C Corporation

As the business grows and takes on more sophisticated investors (like venture funds), it will most often convert into something called a C Corporation. Most of the companies you would buy stock in on the public markets are C Corporations. Most venture backed companies are C Corporations.

C Corporations provide the limitation of liability, provide even more sophisticated ways to split ownership and raise capital, and most importantly are "tax paying entities." Once you convert from a LLC to a C corporation, you as the founder or owner no longer are responsible for paying the taxes on your share of the income. The company pays those taxes at the corporate level.

There are many reasons why a venture fund or other "sophisticated investors" prefer to invest in a C corporation over a LLC. Most venture funds require conversion when they invest. The flow through of taxes in the LLC can cause venture funds and their investors all sorts of tax issues. This is particularly true of venture funds with foreign investors. And the governance and ownership structures of an LLC are not nearly as developed as a C corporation.

This stuff can get really complicated quickly, but the important thing to know is that when your business is small and "closely held," a LLC works well. When it gets bigger and the ownership gets more complicated, you'll want to move to a C corporation.

S Corporation

A nice hybrid between the C corporation and the LLC is the S corporation. It requires a simpler ownership structure, basically one class of stock and less than 100 shareholders. It is a "flow through entity" and is simple to set up. You cannot do as much with the ownership structure with an S corporation as you can with a LLC so if you plan to stay a flow through entity for a long period of time and raise significant capital, an LLC is probably better.

Limited Partnership

Another entity you might come across is the Limited Partnership. The funds our firm manages are Limited Partnerships. And some big companies, like Bloomberg LP (http://www.bloomberg.com/), are limited partnerships.

The key differences between a Limited Partnership and LLCs and C corporations involve liabilities. In the limited partnership, the investors have limited liability (like a LLC or C corporation) but the managers (called General Partners) do not. Limited Partnerships are set up to take in outside investment and split ownership. And they are flow through entities.

Entrepreneurs and Investors Must Choose Corporate Entities Wisely

The important thing to remember about all of this is that if you are starting a business, you should create a corporate entity to manage the risk and protect you and your family from it. You should start with something simple and evolve it as the business needs grow and develop.

As an investor, you should make sure you know what kind of corporation you are investing in, you should know what kind of liability you are exposing yourself to, and what the tax obligations will be as a result.

And most of all, get a good lawyer and tax advisor. Though they are expensive, over time the best ones are worth their weight in gold.

II.

Chapter 2: "Who Are" Your Leaders?

Part 1: What A CEO Does

If you cannot do these three things well, you will not be a great CEO.

The CEO, Chief Executive Officer, is the company’s leader. We all have images of CEOs, positive and negative. But it’s important to know what a CEO actually does, and I’m not talking about something written in an official job description or fancy corporate biography. The little lesson that follows was not something I learned at business school. I learned it from a very experienced venture capitalist early in my post-MBA career.

I was working on a CEO search for one of our struggling portfolio companies. We had a bunch of them. I started in the venture capital business just as the PC hardware bubble of the early 80s was busting. Our portfolio was a mess. It was a great time to enter the business. I cleaned up messes for my first few years. I learned a lot.

One of the board members was a very experienced VC who had been in the business around 25 years by then. I asked him "what exactly does a CEO do?"

He answered without thinking:

“A CEO does only three things.”

- Sets the overall vision and strategy of the company and communicates it to all stakeholders.
- Recruits, hires, and retains the very best talent for the company.
- Makes sure there is always enough cash in the bank.

I asked, "Is that it?"

He replied that the CEO should delegate all other tasks to his or her team.

I've thought about that advice so often over the years. I evaluate CEOs on these three metrics all the time. I've learned that great CEOs can and often will do a lot more than these three things. And that is OK.

But I have also learned that if you cannot do these three things well, you will not be a great CEO.

It is almost 25 years since I got this advice. And now I am passing it on. It has served me very well over the years.

Matt Blumberg, CEO of our portfolio company Return Path (http://www.returnpath.net/) offers the following additional insight on what a CEO does:

First, three corollaries – one for each of the three responsibilities outlined above:

Setting vision and strategy are key…but in order to do that, the CEO must remember the principle of NIHITO (Nothing Interesting Happens in the Office) and must spend time in-market. Get to know competitors well. Spend time with customers and channel partners. Actively work industry associations. Walk the floor at conferences. Understand what the substitute products are (not just direct competition).

Recruiting and retaining top talent are pay-to-play…but you have to go well beyond the standards and basics here. You have to be personally involved in as much of the process as you can – it's not about delegating it to HR. I find that fostering all-hands engagement is a CEO-led initiative. Regularly conduct random roundtables of 6-10 employees. Send your Board reports to ALL (redact what you must) and make your all-hands meetings Q&A instead of status updates. Hold a CEO Council every time you have a tough decision to make and want a cross-section of opinions.

Making sure there's enough cash in the bank keeps the lights on…but managing a handful of financial metrics in concert with each other is what really makes the engine hum. A lot of cash with a lot of debt is a poor position to be in. Looking at recognized revenue when you really need to focus on bookings is shortsighted. Managing operating losses as your burn/runway proxy when you have huge looming CapEx needs is a problem.

Second, three behaviors a CEO has to embody in order to be successful – this goes beyond the job description into key competencies.

Don't be a bottleneck. You don't have to be an Inbox-Zero nut, but you do need to make sure you don't have people in the company chronically waiting on you before they can take their next actions on projects. Otherwise, you lose all the leverage you have in hiring a team.

Run great meetings. Meetings are a company's most expensive endeavors. 10 people around a table for an hour is a lot of salary expense! Make sure your meetings are as short as possible, as actionable as possible, and as interesting as possible. Don't hold a meeting when an email or 5-minute recorded message will suffice. Don't hold a weekly standing meeting when it can be biweekly. Vary the tempo of your meetings to match their purpose – the same staff group can have a weekly with one agenda, a monthly with a different agenda, and a quarterly with a different agenda.

Keep yourself fresh. Join a CEO peer group. Work with an executive coach. Read business literature (blogs, books, magazines) like mad and apply your learnings. Exercise regularly. Don't neglect your family or your hobbies. Keep the bulk of your weekends, and at least one two-week vacation each year, sacrosanct and unplugged.

There are a million other things to do, or that you need to do well…but this is a good starting point for success.

Part 2:The 3 Functions Of A Management Team

CEO Matt Blumberg offers more leadership insight. Here he describes what a management team does by identifying their 3 key functions:

After a quarterly Return Path exec team offsite, my team and I were rehashing the day's conversation over dinner. Was it a good day or a bad day? An upper or a downer? We concluded that the day was as it should have been – a good mix of what I will now articulate as the three main functions of a management team. Here they are with some color:

- Create an environment for success: Do people like to come to work every day? When they get there, do they know what they're supposed to do, and how it connects to the company's mission? Are people learning and growing? Are you building an enduring organization beyond you as a leader?
- Nip problems in the bud, or prevent them entirely: Are you spending enough time thinking about your business's vulnerabilities? Do you go into a dark cave of paranoia once in a while and make sure you're cognizant of all the main potential threats to your livelihood? What can you do to spot smoke as an early warning detection of fire?
- Exploit big opportunities: Do you know the top 5 things that will make your company successful? Are you constantly on the lookout for signs that it's time to invest more heavily in them? Are you nimble enough to make those investments when the time is right...and have you developed the intellectual or infrastructural underpinnings to make those investments matter?

I'm not sure there's any order or weighting to these, at least not over the long haul.

I may be missing some huge swaths of territory as a result of where our company and our team are at this particular moment in time. But after reading this over a few times, it feels right on a more enduring basis.

III.

Chapter 3: Financing Options for Startups

Financing Options

Starting a company is more art than science.

This following list is roughly in chronological order of how a small company might avail itself of the various financing options, but there are always exceptions. Starting a company is more art than science.

- Friends and Family
- Contests/Prizes/Accelerator Programs
- Government Grants
- Customer Financing
- Vendor Financing
- Convertible Debt
- Preferred Stock
- Venture Debt
- Capital Equipment Loans & Leases
- Bridge Loans
- Working Capital Financing

Friends and Family

Friends and family financing is popular because it is easy to get a hearing from the people who know you best and they are positively inclined to say yes. But there are some negatives as well. It's tough to know how to price and structure an investment where the investors are close friends or family. You don't want to take advantage of them and they may not be sophisticated enough to know what is a good deal and what is a bad deal.

Make Sure Friends and Family Know the Risks

Probably the trickiest part of friends and family financing is that you really don't want to lose money that friends and family have invested with you. And most startups fail so the chances that will happen are high. I would encourage entrepreneurs who take funding from friends and family to be very clear about the risks and downside. I would also suggest only taking capital from friends and family members who can afford to lose the investment.

Discount Notes: The Best Approach for Friends and Family

Convertible notes are recommended friends and family financings with a discount and a cap on the valuation. That way you don't have to worry about how to price the investment. A 20-25% discount from the next round is appropriate. While the valuation cap is going to vary depending on the size of the raise and the size of the opportunity, I'd suggest a cap that gives the friends and family around 10% of the business if things work out.

Contests/Prizes/Accelerator Programs

This is a group of option that has become a lot more available to entrepreneurs in recent years. There are so many programs out there that target entrepreneurs where the winner(s) is/are awarded cash prizes or small equity investments.

Accelerator Programs

Accelerator programs will require you and your founding team to relocate to a set location for around three months and participate in a program. The equity investment varies but is generally in the range of $25,000 to $30,000. The equity you will give up for this cash is usually in the range of 5-6%. The biggest value comes from the mentoring and the opportunity to pitch to a large group of angel investors on the last day of the program.

Y Combinator is a pioneer accelerator: http://ycombinator.com/

Contests and Prizes

Contests and prizes have been around for a lot longer but there has also been an explosion of them in recent years. One of my favorite is the NYC Big Apps contest (http://2011.nycbigapps.com/) where developers compete to build the best app that uses data from the NYC open data project. The winning team gets a prize of $40,000 with no equity dilution. The winners of NYC Big Apps the past two years have gone on to create real businesses with funding and user traction.

You are not likely to fund your business all the way to cash flow breakeven on the money you get from an accelerator program or winning a contest (although I'm sure someone has done it). It can give you the money (and connections) you need to get going and get somewhere and set yourself up for the next funding source.

Government Grants

Governments will provide capital for startups (http://www.grants.gov/aboutgrants/eligibility.jsp) and I've seen many entrepreneurs over the years take advantage of this form of financing. The grants are usually "free money" in the sense that they do not need to be paid back and they don't cost any equity.

But nothing in life is free. You do pay for this money in ways that may not be in your interest. The application process is usually long, involved, and distracting. And sometimes the grants come with strings attached; you can't move, you have to use it for a specific purpose, you have to hire a certain number of people with it, etc, etc.

Not a Financial Silver Bullet

I'm not a fan of this form of financing. First, in principle I think that government ought to stay out of the business of picking winners and let the market do that. But more practically, I've never seen an entrepreneur change the outcome of their startup with government money. It is never enough to really move the needle and the strings that are attached usually make it uninteresting to me.

Customer Financing

Customers are a great way to finance a business for many reasons. First, customer financing is typically non dilutive. Customers also help you fit your product to the market and help debug and improve the quality of the product.

How Customers Can Further Product Development

The most common way customer financing is done is you sell the customer on the product before you've built it or before you've finished it. The customer puts up the money to build the product or finish the product and becomes your first customer. An early customer might ask for some exclusivity on the product, but most of the time the early customer simply wants the product from you and nothing more.

Limitations of Customer Financing

It isn’t always possible to find a customer who will put up money in advance of the product being complete and ready to use. It takes great salesmanship to convince a customer to buy something from you that isn't built or isn't finished. But even if you can convince a customer to do this, there are some negatives.

Building a product explicitly for one customer often makes it less applicable to the market as a whole. An early customer who provides funding to build your product will want the product tailored specifically for its needs.

Second, you risk building a "fee for services culture" in your company with this approach. Some companies build products for customers for a fee. Other companies build products and sell them "as is" to customers. The latter is the scalable model for building valuable companies.

Customer financing is much more difficult, if not impossible, in consumer-facing services. It is much more applicable in business-facing services.

Vendor Financing

The more capital intensive your startup is, the more you can and should think about vendor financing. Two reasonably common examples in the world of tech startups are equipment financing and development for equity.

Equipment financing is when a vendor of capital equipment, like servers, agrees to sell you their product and takes a loan or a lease instead of cash. Development for equity is when a third party development firm builds something for you and takes equity in your business (or less commonly, a loan) in return for the development services.

In the biotech and cleantech sectors, vendor financing is more common. These sectors have large capital equipment requirements and large third party services requirements. There is a lot of money laid out to third party vendors on the way to cash breakeven and therefore a much greater opportunity to have those vendors finance the business.

Convertible Debt

Convertible debt (also known as convertible loans or convertible notes) is when a company borrows money from an investor or a group of investors and the intention of both the investors and the company is to convert the debt to equity at some later date. Such financing can include compensation in the form of a discount or a warrant and a cap on the valuation at which the debt will convert.

There are a number of reasons why the investors and/or the company would prefer to issue debt instead of equity and convert the debt to equity at a later date. If the company believes its equity will be worth more at a later date, then it will dilute less by issuing debt and converting it later. It is also true that the transaction costs, mostly legal fees, are usually less when issuing debt vs. equity.

For investors, the preference for debt vs. equity is less clear. Sometimes investors are so eager to get the opportunity to invest in a company that they will put their money into a convertible note and let the next round investors set the price. They believe that if they insisted on setting a price now, the company would simply not take their money. Sometimes investors believe that the compensation, in the form of a warrant or a discount, is sufficiently valuable that it offsets the value of taking debt vs. equity.

Friends and family rounds (see previous) are often done via convertible debt. It makes sense that friends and family would not want to enter into a hardball negotiation with a founder and would prefer to let the price discussion happen when professional investors enter the equation.

Warrants, Discounts and Caps

The typical forms of compensation for making a convertible loan are warrants or a discount.

In the typical convertible note, the warrant will be an option for whatever security is sold in the next round. The warrant is most often expressed in terms of “warrant coverage percentage.” For example “20% warrant coverage” means you take the size of the convertible note, say $1mm, multiply it by 20%, which gets you to $200,000, and the warrant will be for $200,000 of additional securities in the next round.

A discount is simpler to understand but often more complicated to execute. A discount will also be expressed in terms of a percentage. The most common discounts are 20% and 25%. The discount is the amount of reduction in price the convertible loan holders will get when they convert in the next round.

Convertible notes also typically have some cap on the valuation at which they can convert. That cap is anywhere from the current valuation (not very common) to a multiple of the current valuation. Recently we are starting to see uncapped convertible notes. These notes have no cap on the valuation at which they can convert.

When Convertible Debt Makes Sense

Startups typically think about raising capital via convertible debt early on in the life of a startup. They want to move fast, keep transaction costs low, and they are often dealing with a syndicate of angel investors and it is easier to get the round done with a convertible note than a seed or series A round.

However, later on in a company's life convertible debt can make more sense. A few years ago, we had a portfolio company that was planning on an exit in a year to two years and needed one last round of financing to get there. They talked to VCs and figured out how much dilution they would take for a $7mm to $10mm raise.

Then they went to Silicon Valley Bank and talked to the venture debt group. In the end, they raised $7.5mm of venture debt, issued SVB some warrants as compensation for making the loan, and built the company for another year, sold it, and did much better in the end because they avoided the dilution of the last round.

Preferred Stock

Preferred stock is a class of stock that provides certain rights, privileges, and preferences to investors. Compared to common stock, which is normally held by the founders, it is a superior security. Almost all venture capital firms and many angel and seed investors will require the company they are investing in to issue them preferred stock.

Liquidation Preferences

Preferred stock takes its name from a critical feature of preferred stock called liquidation preference. Liquidation preference means that in a sale (or liquidation) of the company, the preferred stock holders will have the option of taking their cost out or sharing in the proceeds with the founders as common stock holders. What this means is that if the value of the sale of the company is below the valuation the preferred investors paid, then they will get their money back.

Investor Rights and Privileges

There are a number of important rights and privileges that investors secure via a preferred stock purchase, including:

- A right to a board seat
- Information rights
- A right to participate in future rounds to protect their ownership percentage (called a pro-rata right)
- A right to purchase any common stock that might come onto the market (called a right of first refusal)
- A right to participate alongside any common stock that might get sold (called a co-sale right)

- An adjustment in the purchase price to reflect sales of stock at lower prices (called an anti-dilution right)

Negotiate Preferred Stock Carefully

As a wise man likes to say, "In life you don't get what you deserve, you get what you negotiate." When you are preparing to sell preferred stock to investors, make it a point to familiarize yourself with all the important terms, what they mean (both to you and your company), and what an "entrepreneur friendly" deal looks like.

Then **go get a good investor for you and your company**. It helps to have some leverage and leverage in financings means multiple investors at the table. So when you are dealing with sophisticated investors, make sure you have options and make sure you understand the key issues and don't settle for a bad deal.

Preferred stock doesn't have to be a bad deal for entrepreneurs. It can be a win/win for both sides. But you have to work at this part of your business just like you do at the other parts.

Venture Debt

If there were two words less likely to be found together, it would be venture and debt. Startups are not credit worthy enterprises. They have little to no assets and no cash flow. Equity is the appropriate way to finance startups.

However, there is a large, growing, and vibrant market for something called Venture Debt. It is indeed debt, largely provided by a number of banks and finance companies who specialize in this market. The following are components of venture debt:

- **The term:** how long you have to pay back the loan. Three years is the typical term for Venture Debt.
- **Interest only:** you pay the interest on the loan each month but you don't pay the loan down each month.
- **Balloon payment:** you pay the loan amount in full when the term expires.
- **Warrants:** like options, you get the right to buy equity at a fixed price for a period of time, usually five or ten years.
- **Equity kicker:** an equity component to the deal to goose the returns.

Eligibility for Venture Debt

Venture Debt is available largely to companies that have secured at least one round of venture capital financing by a recognized venture capital firm or syndicate of venture capital firms. It is also available to more developed startups that are credit worthy by virtue of significant assets or cash flow.

When banks issue venture debt, they are not loaning against the credit worthiness of the startups; they are loaning against the creditworthiness of the venture capital firm or syndicate. The banks are betting the VCs will keep funding the company well past the term of the venture debt loan.

When Venture Debt Makes Sense

If an early stage company is getting the money because of the credit worthiness of my firm and the other firms in the deal, then I'd rather be putting more equity in instead and getting paid for my capital at risk.

I am a big fan of venture debt late in the life of the startup. It can be a bridge to a sale or a bridge to an IPO or can be used to fund an acquisition or some other value enhancing transaction. It is smart to use debt vs. equity when you can absolutely pay the debt back.

Capital Equipment Loans and Leases

Equity capital is expensive. Every time you do a raise, you dilute. It makes sense to look for places where you can use other less expensive forms of capital to fund growth. Capital equipment provides an opportunity for debt financing because you can borrow against the equipment.

Capital Equipment Loans

Capital equipment loans are loans made by banks and finance companies to provide a company the funds to aquire the capital equipment. The company owns the servers, computers, etc and puts them on its books. The company also has a loan obligation on its books to the bank or finance company.

The loan is collateralized meaning that if the company defaults on the loan, the bank or finance company can come take the equipment. The equipment is the security for the loan. These loans are usually self amortizing term loans of around 3 years and carry interest rates of between 6% and 12% depending on the financial profile of the borrower.

Capital Equipment Leases

Leases are a financing tool used by the manufacturers of equipment (and sometimes by banks and finance companies too). Let’s say you want to purchase a bunch of servers to run your web application. The server company can lease the servers to your company instead of selling them to you. Under a typical lease deal, you will pay the lessor a fixed monthly amount for a fixed term, typically three or four years.

At the end of the term, your company will have the option to buy the servers for a nominal amount or give them back to the lessor. Some leases will be capitalized and end up on your books and look a lot like capital equipment loans. Other leases will not end up on your books and will look more like renting an office.

Advantages of Capital Equipment Loans and Leases

In both cases, you are getting capital you need to finance growth without diluting. And the primary reason for that is the equipment itself provides the security for the loan, not your company, which is likely not credit worthy.

The risks and rewards are well aligned for both the lender and the borrower and it makes sense for both parties to do these transactions. Don't use your precious funds raised in dilutive equity rounds to buy servers and other capital equipment. Go see a bank, finance company, or manufacturer about a financing arrangement.

Bridge Loans

Bridge loans are so called because they are a "bridge" to something else. They are short-term loans intended to fund a company to an anticipated event in the future. Big banks will often bridge companies to transactions they are putting together for them. Real estate transactions are often bridged to a closing.

The Risk of Bridge Loans

Most bridge loans in the startup world are made to money losing companies that are going to run out of funds before they can close a financing or sale transaction. These are very risky loans that will not get paid back unless a transaction happens and often the transactions that are required don't happen.

When making a bridge loan, it is critical that the size of the loan be sufficient to get to the transaction you are bridging to. You want the bridge to be long enough to cross the river. So if you think you need three months to sell the company or get a financing done, get six months of burn in your bridge.

Typical Terms and Rates

The loan will be secured by all the assets of the business that can be pledged. If there is existing bank debt or equipment financing, the bridge will be subordinate to those loans. And you will need the bank's cooperation getting a bridge done if there is a bank involved. Sometimes that is not easy.

The loan will carry an interest rate of between 6% and 12% depending on the current rate environment and will have warrant coverage or a discount. Bridge loans are a specialized form of convertible debt.

A Reality for Startups

In summary, bridge loans are common in all businesses. For startup investors, bridge loans in the aggregate are a poor performing investment and as an industry, we dislike making them. But like all of the tools at our disposal in the statup world, bridge loans are a reality of our lives.

Working Capital Financing

Working capital financing relies on a company's balance sheet to support the loan so understanding how a balance sheet works is important to understanding working capital financing.

When Working Capital Financing May Be Necessary

Working capital is equal to current assets minus current liabilities. In layman's terms, working capital is what your customers owe you plus any inventory you have built up minus what you owe your suppliers and employees. Working capital also includes any cash you have in the bank. When a business is making plenty of money on paper but can't manage its cash needs, it has a working capital issue. And the faster a company grows, the worse it can get.

How Banks Issue Working Capital Financing

Banks and finance companies will loan companies, particularly profitable companies, the money they need to purchase inventory and wait to get paid by their customers. Banks will rely on the purchase orders on hand and the actual value of the inventory that the company has in stock to backup the loan. They will also take into account the money the company owes its suppliers and employees in determining exactly how much capital to loan the company.

Most working capital financing has built in cushions. Banks will typically loan 50-75% on the dollar of working capital, increasing the size of the loans they make as working capital grows. These are all short-term loans because the inventory eventually gets sold and the customers eventually pay. A typical way these loans are structured are lines of credit and revolvers meaning that as the money comes back into the business, the loans get repaid, but the total amount available under the loan stays the same so the company can just borrow it back when it needs the money again.

For companies that are particularly shaky, there is a technique known as "factoring" where the bank actually takes the amounts of money due from the customers as collateral and gets paid directly by the customers and then remits the extra amounts to the company. The bank essentially becomes the accounts receivable department of the company.

A Smart and Necessary Choice

Even a software-based business can build up a lot of working capital. It usually results from the company having to pay its obligations much faster than its customers are paying the company. If you have customers that pay in 90 days and you are growing revenues quickly, then you can find yourself in a major cash squeeze. Working capital financing is a great way to manage that kind of cash squeeze.

IV.

Chapter 4: Employee Equity Part 1

Ownership In The Company

When you join a startup, you have the expectation of getting some ownership in the company.

One of the defining characteristics of startup culture is **employee ownership**. Many large companies provide employee ownership so this is not unique to startup culture. But when you join a startup, you have the expectation of getting some ownership in the company and if the company is successful and is sold or taken public, that you will share in the gains that result.

Employee ownership is an important part of startup culture. It reinforces that everyone is on the team, everyone is sharing in the gains, and everyone is a shareholder. I can't think of a company that has come to pitch us that has not had an employee equity plan. And I can't think of a term sheet that we have issued that didn't have a specific provision for employee equity. It is simply a fundamental part of the startup game.

Read this *Harvard Business Review* article on the importance of employee equity to a company’s long-term success: http://hbr.org/2005/06/every-employee-an-owner-really/ar/1.

Different Levels Of Employee Ownership

While employee equity is "standard" in the startup business, the levels of employee ownership vary quite a bit from company to company. There are a variety of reasons. **Geography matters.** Employee ownership levels are higher in well developed startup cultures like the Bay Area, Boston, and NYC. They are lower in less-developed startup communities. Engineering heavy startups will tend to have higher levels of employee ownership than services and media companies.

If the founders are the top managers in the company, then the typical "non founder employee ownership" will tend to be between 10% and 20%. If the founders have largely left the company, then "non founder employee ownership" will be closer to 20% and could be a bit higher. The people providing the "sweat equity" typically get 20% of the gains in our business (at USV we get 20%) and they should get at least that in the companies we back. I say "at least" because the founders are often still providing "sweat equity" and they can own much more than 20%.

Primary Forms of Employee Equity

There are 4 primary ways to issue employee equity in startups:

1.) Founder stock. This is the stock that founders issue to themselves when they form the company. It can also include stock issued to early team members. Founder stock has special vesting provisions among the founders so that one or more of them doesn't leave early and keep all of their stock. Those vesting provisions are extended to the investors once capital is invested in the business. Founder stock will typically be common stock and it will be owned by the founders subject to vesting provisions.

2.) Restricted stock. This is common stock that is issued to either early employees or top executives that are hired into the company fairly early in a company's life. Restricted stock will have vesting provisions that are identical to standard employee option plans (typically 4 years but sometimes 3 years).

The difference between restricted stock and options is that the employee owns the shares from the day of issuance and can get capital gains treatment on the sale of the stock if it is held for one year or more. Issuing restricted stock to an employee triggers immediate taxable income to the recipient. It can be very expensive to the recipient and therefore it is only done very early when the stock is not worth much or when a senior executive is hired who can handle the tax issues.

3.) Options. This is by far the most common form of employee equity issued in startup companies. The stock option is a right issued to an employee to purchase common stock at some point in the future at a set price. The "set price" is called the "strike price."

4.) Restricted Stock Units. Known as RSUs, these securities are relatively new in the startup business. They were created to fix issues with options and restricted stock and have characteristics of both. A RSU is a promise to issue common stock once the vesting provisions have been satisfied. The vesting provisions can include a liquidity event. So when you are getting an RSU, you are getting something that feels like an option but there is no strike price. When you get the shares, you will own them outright but might not get them for a while.

I implore all of you entrepreneurs to hire an experienced startup lawyer. Employee equity issues are tricky. You can and will make a bunch of expensive mistakes with employee equity unless you have the right counsel. There are plenty of law firms and lawyers who specialize in startups and you should have one of them at your side when you are setting up your company and throughout its life.

For deeper detail on equity, read these blog posts:

Employee Equity: Dilution

http://mba-mondays.pandamian.com/employee-equity-dilution/

Employee Equity: Appreciation

http://mba-mondays.pandamian.com/employee-equity-appreciation/

Employee Equity: The Liquidation Overhang

http://mba-mondays.pandamian.com/employee-equity-the-liquidation-overhang/

Employee Equity: The Option Strike Price

http://mba-mondays.pandamian.com/employee-equity-the-option-strike-price/

Employee Equity: Restricted Stock and RSUs

http://mba-mondays.pandamian.com/employee-equity-restricted-stock-and-rsus/

V.

Chapter 5: Employee Equity Part 2

Options

If you are joining a startup, you are most likely going to receive stock options as part of your compensation.

A stock option is a security which gives the holder the right to purchase stock (usually common stock) at a set price (called the strike price) for a fixed period of time. Stock options are the most common form of employee equity and are used as part of employee compensation packages in most technology startups.

If you are a founder, you are most likely going to use stock options to attract and retain your employees. If you are joining a startup, you are most likely going to receive stock options as part of your compensation. This post is an attempt to explain how options work and make them a bit easier to understand.

The Tax Advantages of Options

Stock has a value. If your company is giving out stock as part of the compensation plan, you'd be delivering something of value to your employees and they would have to pay taxes on it just like they pay taxes on the cash compensation you pay them.

Let's say that the common stock in your company is worth $1/share. And let's say you give 10,000 shares to every software engineer you hire. Then each software engineer would be getting $10,000 of compensation and they would have to pay taxes on it.

But if this is stock in an early stage company, the stock is not liquid; it can't be sold right now. So your employees are getting something they can't turn into cash right away but they have to pay roughly $4,000 in taxes as a result of getting it. That's not good and that's why options are the preferred compensation method.

If your common stock is worth $1/share and you issue someone an option to purchase your common stock with a strike price of $1/share, then at that very moment in time, that option has no exercise value. It is "at the money" as they say on Wall Street.

The tax laws are written in the U.S. to provide that if an employee gets an “at the money” option as part of their compensation, they do not have to pay taxes on it. The laws have gotten stricter in recent years and now most companies do something called a 409a valuation of their common stock to insure that the stock options are being struck at fair market value.

Most stock options in startups have a long holding period. It can be five years and it often can be ten years. So if you join a startup and get a five year option to purchase 10,000 shares of common stock at $1/share, you are getting something of value. But you do not have to pay taxes on it as long as the strike price of $1/share is “fair market value” at the time you get the option grant. That explains why options are a great way to compensate employees.

Using Options to Attract and Retain Talent

Stock options are both an attraction and a retention tool. The retention happens via a technique called “vesting.” (see following chapter for more information) Vesting usually happens over a 4-year term, but some companies do use 3-year vesting. The way vesting works is your options don’t belong to you in their entirety until you have vested into them.

If it were to vest over 4 years, you would take ownership of the option at the rate of 2,500 shares per year. Many companies “cliff vest” the first year meaning you don’t vest into any shares until your first anniversary. After that most companies vest monthly.

The nice thing about vesting is that you get the full grant struck at the fair market value when you join and even if that value goes up a lot during your vesting period, you still get that initial strike price. Vesting is much better than doing an annual grant every year which would have to be struck at the fair market value at the time of grant.

Exercising an option is when you actually pay the strike price and acquire the underlying common stock. In our example, you would pay $10,000 and acquire 10,000 shares of common stock. Obviously this is a big step and you don’t want to do it lightly.

There are two common times when you would likely exercise. The first is when you are preparing to sell the underlying common stock, mostly likely in connection with a sale of the company or some sort of liquidity event like a secondary sale opportunity or a public offering.

You might also exercise to start the clock ticking on long term capital gains treatment. The second is when you leave the company. Most companies require their employees to exercise their options within a short period after they leave the company. Exercising options has a number of tax consequences. Be careful when you exercise options and get tax advice if the value of your options is significant.

VI.

Chapter 6: Employee Equity Part 3

Vesting

Companies grant stock or options upfront when the employee is hired and vest the stock over a set period of time.

Vesting is the technique used to allow employees to earn their equity over time. You could grant stock or options on a regular basis and accomplish something similar, but that has all sorts of complications and is not ideal. So instead companies grant stock or options upfront when the employee is hired and vest the stock over a set period of time. Companies also grant stock and options to employees after they have been employed for a number of years. These are called retention grants and they also use vesting.

Vesting Schedules

Vesting works a little differently for stock and options. In the case of options, you are granted a fixed number of options but they only become yours as you vest. In the case of stock, you are issued the entire amount of stock and you technically own all of it but you are subject to a repurchase right on the unvested amount. While these are slightly different techniques, the effect is the same. **You earn your stock or options over a fixed period of time.**

Vesting periods are not standard but I prefer a 4-year vest with a retention grant after 2 years of service. That way no employee is more than half vested on their entire equity position. Another approach is to go with a shorter vesting period, like 3 years, and do the retention grants as the employee becomes fully vested on the original grant.

I like that approach less because there is a period of time when the employee is close to fully vested on their entire equity position. It is also true that 4-year vesting grants tend to be slightly larger than 3-year vesting grants and I like the idea of a larger grant size.

If you are an employee, the thing to focus on is how many stock or options you vest into every year. The size of the grant is important but the annual vesting amount is really your equity based compensation amount.

Cliff Vesting

Most vesting schedules come with a 1-year cliff vest. That means you have to be employed for 1 full year before you vest into any of your stock or options. When the first year anniversary happens, you will vest a lump sum equal to one year's worth of equity and normally the vesting schedule will be monthly or quarterly after that.

Cliff vesting is not well understood but it is very common. The reason for the 1-year cliff is to protect the company and its shareholders (including the employees) from a bad hire which gets a huge grant of stock or options but proves to be a mistake right away. A cliff vest allows the company to move the bad hire out of the company without any dilution.

There are a couple things about cliff vesting worth discussing. First, if you are close to an employee's anniversary and decide to move them out of the company, you should vest some of their equity even though you are not required to do so.

If it took you a year to figure out it was a bad hire then there is some blame on everyone and it is just bad faith to fire someone on the cusp of a cliff vesting event and not vest some stock. It may have been a bad hire but a year is a meaningful amount of employment and should be recognized.

The second thing about cliff vesting that is problematic is if a sale happens during the first year of employment. I believe that the cliff should not apply if the sale happens in the first year of employment. When you sell a company, you want everyone to get to go to the "pay window" as JLM calls it. And so the cliff should not apply in a sale event.

Vesting and Change of Control

When a sale event happens, your vested stock or options will become liquid (or at least will be "sold" for cash or exchanged for acquirer's securities). Your unvested stock and options will not. Many times the acquirer assumes the stock or option plan and your unvested equity will become unvested equity in the acquirer and will continue to vest on your established schedule.

So sometimes a company will offer accelerated vesting upon a change of control to certain employees. This is not generally done for the everyday hire. But it is commonly done for employees that are likely going to be extraneous in a sale transaction. CFOs and general counsels are good examples of such employees.

It is also true that many founders and early key hires negotiate for acceleration upon change of control. I advise our companies to be very careful about agreeing to acceleration upon change of control. I've seen these provisions become very painful and difficult to deal with in sale transactions in the past.

And I also advise our companies to avoid full acceleration upon change of control and to use a "double trigger." Full acceleration upon change of control means all of your unvested stock becomes vested. That's generally a bad idea. But an acceleration of 1 year of unvested stock upon change of control is not a bad idea for certain key employees, particularly if they are likely to be without a good role in the acquirer's organization.

The double trigger means two things have to happen to get the acceleration. The first is the change of control. The second is a termination or a proposed role that is a demotion (which would likely lead to the employee leaving).

VII.

Chapter 7: Employee Equity Part 4

How Much?

Getting someone to join your dream before it is much of anything is an art, not a science.

There is always one questions surrounding employee equity: *How much should the company give people?* For your first key hires, perhaps 3 to 10 people, you will probably not be able to use any kind of formula.

Getting someone to join your dream before it is much of anything is an art, not a science. And the amount of equity you need to grant to accomplish these hires is also an art and most certainly not a science. However, a rule of thumb for those first few hires is that you will be granting them in terms of points of equity (i.e., 1%, 2%, 5%, 10%). To be clear, these are hires we are talking about, not co-founders.

Once you have assembled a core team that is operating the business, you need to move from art to science in terms of granting employee equity. And most importantly you need to move away from points of equity to the dollar value of equity. Giving out equity in terms of points is very expensive and you need to move away from it as soon as it is reasonable to do so.

The Equity Formula

You should use a formula to determine equity. The following formula came from a big compensation consulting firm we hired when I was on the board of a company that was going public. I've modified it in a few places to simplify it. But it is based on a common practice in compensation consulting and the dollar value of equity.

First, figure out how valuable your company is (we call this "**best value**"). This is NOT your 409a valuation (we call that "**fair value**"). This "best value" can be:

- The valuation on the last round of financing
- A recent offer to buy your company that you turned down
- The discounted value of future cash flows
- A public market comp analysis

Whatever approach you use, it should be the value of your company that you would sell or finance your business at right now.

Let's say the number is $25mm. This is an important data point for this effort. The other important data point is the number of fully diluted shares. Let's say that is 10mm shares outstanding.

Using Multipliers to Determine Equity

The second thing you do is break up your org chart into brackets. There is no bracket for the CEO and COO. Grants for CEOs and COOs should and will be made by the Board. The first bracket is the senior management team; the CFO, Chief Revenue Officer/VP Sales, Chief Marketing Officer/VP Marketing, Chief Product Officer/VP Product, CTO, VP Eng, Chief People Officer/VP HR, General Counsel, and anyone else on the senior team.

The second bracket is Director level managers and key people (engineering and design superstars for sure). The third bracket includes employees who are in the key functions like engineering, product, marketing, etc. And the fourth bracket includes employees who are not in key functions. This could include reception, clerical employees, etc.

When you have the brackets set up, you put a multiplier next to them. There are no hard and fast rules on multipliers. You can also have many more brackets than four. I am sticking with four brackets to make this simple. Here are our default brackets:

- Senior Team: 0.5x
- Director Level: 0.25x
- Key Functions: 0.1x
- All Others: 0.05x

EQUITY MULTIPLIER CHART **Multiply by Yearly Salary to Determine Equity Received**		
Organizational Bracket	**Members**	**Equity Multiplier**
Senior Team	C-level **OTHER THAN** CEO, COO; executives (SVP, VP, etc.)	0.5x
Director Level	Directors and equivalent managers, engineering and design “superstars”	0.25x
Key Functions	Engineering, product, marketing	0.1x
All Others	Reception, clerical	0.05x

Then you multiply the employee's base salary by the multiplier to get to a dollar value of equity. Let's say your VP Product is making $175k per year. Then the dollar value of equity you offer them is 0.5 x $175k, which is equal to $87.5k. Let's say a director level product person is making $125k. Then the dollar value of equity you offer them is 0.25 x $125k which is equal to $31.25k.

Then you divide the dollar value of equity by the "best value" of your business and multiply the result by the number of fully diluted shares outstanding to get the grant amount. We said that the business was worth $25mm and there are 10mm shares outstanding. So the VP Product gets an equity grant of ((87.5k/25mm) * 10mm) which is 35k shares. And the the director level product person gets an equity grant of ((31.25k/25mm) *10mm) which is 12.5k shares.

(Dollar Value of Equity)

X (Fully Diluted Shares) = **Grant Amount**

(Best Value of Business)

Using Current Share Price to Determine Equity

Another, possibly simpler, way to do this is to use the current share price. You get that by dividing the best value of your company ($25mm) by the fully diluted shares outstanding (10mm). In this case, it would be $2.50 per share. Then you simply divide the dollar value of equity by the current share price. You'll get the same numbers and it is easier to explain and understand.

Communicating Equity

The key thing is to **communicate the equity grant in dollar values, not in percentage of the company**. Startups should be able to dramatically increase the value of their equity over the four years a stock grant vests.

We expect our companies to be able to increase in value three to five times over a four year period. So a grant with a value of $125k could be worth $400k to $600k over the time period it vests. And of course, there is always the possibility of a breakout that increases 10x over that time. Talking about grants in dollar values emphasizes that equity aligns interests around increasing the value of the company and makes it tangible to the employees.

Use this methodology to help answer the question of "how much?" Issuing equity to employees does not have to be an art form, particularly once the company has grown into a real business and is scaling up. Using a methodology, whether it is this one or some other one, is a good practice to promote fairness and rigor in a very important part of the compensation scheme.

VIII.

Chapter 8: Accounting

Record Keeping For Your Business

It's critical to keep good books and records for a business, no matter how small it is.

How do you keep track of the money in a company? It’s called accounting and includes topics such as cash flow, profit and loss, balance sheets, audits, financial statement analysis, and GAAP (Generally Accepted Accounting Principles) accounting. The FASB (Financial Accounting Standards Board) establishes GAAP in the United States (http://www.fasb.org/home).

Accounting is keeping track of the money in a company. It's critical to keep good books and records for a business, no matter how small it is.

Important Accounting Principles

Every financial transaction of a company needs to be recorded. This process has been made much easier with the advent of accounting software. For most startups, Quickbooks (http://quickbooks.intuit.com/) will do in the beginning. As the company grows, the choice of accounting software will become more complicated, but by then you will have hired a financial team that can make those choices.

The recording of financial transactions is not an art. It is a science and a well understood science. It revolves around the twin concepts of a "chart of accounts" and "double entry accounting."

The accounting books of a company start with a chart of accounts. There are two kinds of accounts:

- Income/expense accounts
- Asset/liability accounts.

The chart of accounts includes all of them. Income and expense accounts represent money coming into and out of a business. Asset and liability accounts represent money that is contained in the business or owed by the business.

Advertising revenue that you receive from Google Adsense would be an income account. The salary expense of a developer you hire would be an expense account. Your cash in your bank account would be an asset account. The money you owe on your company credit card would be called "accounts payable" and would be a liability.

When you initially set up your chart of accounts, the balance in each and every account is zero. As you start entering financial transactions in your accounting software, the balances of the accounts goes up or possibly down.

The concept of double entry accounting is important to understand. Each financial transaction has two sides to it and you need both of them to record the transaction. Let's go back to that Adsense revenue example.

You receive a check in the mail from Google. You deposit the check at the bank. The accounting double entry is you record an increase in the cash asset account on the balance sheet and a corresponding equal increase in the advertising revenue account. When you pay the credit card bill, you would record a decrease in the cash asset account on the balance sheet and a decrease in the "accounts payable" account on the balance sheet.

These accounting entries can get very complicated with many accounts involved in a single recorded transaction, but no matter how complicated the entries get the two sides of the financial transaction always have to add up to the same amount. The entry must balance out. That is the science of accounting.

Once you have a chart of accounts and have recorded financial transactions in it, you can produce reports. These reports are simply the balances in various accounts or alternatively the changes in the balances over a period of time.

Don’t Skimp on Accounting

If you have a company, you must have financial records for it. And they must be accurate and up to date. I do not recommend doing this yourself. I recommend hiring a part-time bookkeeper to maintain your financial records at the start. A good one will save you all sorts of headaches. As your company grows, eventually you will need a full time accounting person, then several, and at some point your finance organization could be quite large.

There is always a temptation to skimp on this part of the business. It's not a core part of most businesses and is often not valued by many entrepreneurs. But please don't skimp on this. Do it right and well. And hire good people to do the accounting work for your company. It will pay huge dividends in the long run.

For more information about financial statements, visit this blog post:

Analyzing Financial Statements

http://mba-mondays.pandamian.com/analyzing-financial-statements/

IX.

Chapter 9: Accounting Part 1

The Profit And Loss Statement

A report of the revenue and expense accounts.

The profit and loss statement is a report of the changes in the income and expense accounts over a certain period of time (month and year being the most common). The most common periods of time are months, quarters, and years, although you can produce a P&L report for any period.

Top Line: Revenue

The top line of profit and loss statements is revenue (that's why you'll often hear revenue referred to as "the top line"). Revenue is the total amount of money you've earned coming into your business over a set period of time. It is NOT the total amount of cash coming into your business. Cash can come into your business for a variety of reasons, like financings, advance payments for services to be rendered in the future, payments of invoices sent months ago.

There is a very important, but highly technical, concept called revenue recognition. Revenue recognition determines how much revenue you will put on your accounting statements in a specific time period. For a startup company, revenue recognition is not normally difficult. If you sell something, your revenue is the price at which you sold the item and it is recognized in the period in which the item was sold.

Accural Accounting

This leads to another important concept called accrual accounting. When many people start keeping books, they simply record cash received for services rendered as revenue. And they record the bills they pay as expenses. This is called cash accounting and is the way most of us keep our personal books and records. But a business is not supposed to keep books this way. It is supposed to use the concept of accrual accounting.

Let's say you hire a contract developer to build your iPhone app. And your deal with him is you'll pay him $30,000 to deliver it to you. And let's say it takes him three months to build it. At the end of the three months you pay him the $30,000. In cash accounting, in month three you would record an expense of $30,000.

But in accrual accounting, each month you'd record an expense of $10,000 and because you aren't actually paying the developer the cash yet, you charge the $10,000 each month to a balance sheet account called Accrued Expenses. Then when you pay the bill, you don't touch the P&L; it’s simply a balance sheet entry that reduces Cash and reduces Accrued Expenses by $30,000.

The point of accrual accounting is to perfectly match the revenues and expenses to the time period in which they actually happen, not when the payments are made or received.

Expense Section

With that in mind, let's look at the second part of the P&L, the expense section. You will often see the cost of revenues applied directly against the revenues and a calculation of a net amount of revenues minus cost of revenues, which is called gross margin.

I prefer that **gross margin** be broken out as it is a really important number. Some businesses have very high costs of revenue and very low gross margins. An example would be a retailer, particularly a low price retailer. The gross margins of a discount retailer could be as low as 25%.

The other reason to break out **cost of revenues** is that it will most likely increase with revenues whereas the other expenses may not. The non cost of revenues expenses are sometimes referred to as **overhead**. They are the costs of operating the business even if you have no revenue. They are also sometimes referred to as the **fixed costs** of the business. But in a startup, they are hardly fixed. In layman's terms, they are the costs of making the product, the costs of selling the product, and the cost of running the business.

Income From Operations

Income from operations is equal to revenue minus expenses. If it is a positive number, then your base business is profitable. If it is a negative number, you are losing money. This is a critical number because if you are making money, you can grow your business without needing help from anyone else. Your business is sustainable. If you are not making money, you will need to finance your business in some way to keep it going. Your business is unsustainable on its own.

The line items after "Income From Operations" are the additional expenses that aren't directly related to your core business. They include interest income (from your cash balances), interest expense (from any debt the business has), and taxes owed (federal, state, local, and possibly international). These expenses are important because they are real costs of the business.

I don't pay as much attention to the expenses above because interest income and expense can be changed by making changes to the balance sheet and taxes are generally only paid when a business is profitable. When you deduct the interest and taxes from Income From Operations, you get to the final number on the P&L, called Net Income.

X.

Chapter 10: Accounting Part 2

The Balance Sheet

A report of the asset and liability accounts.

The balance sheet is report of the balances all asset and liability accounts at a certain point in time. It shows how much capital you have built up in your business. There are two kinds of accounts in a company's chart of accounts; revenue and expense accounts and asset and liability accounts.

The **Profit and Loss** statement (see previous) is a report of the revenue and expense accounts. The Balance Sheet is a report of the asset and liability accounts. Assets are things you own in your business, like cash, capital equipment, and money that is owed to you for products and services you have delivered to customers. Liabilities are obligations of the business, like bills you have yet to pay, money you have borrowed from a bank or investors.

Top Line: Cash

The top line, cash, is the single most important item on the balance sheet. Cash is the fuel of a business. If you run out of cash, you are in big trouble unless there is a "filling station" nearby that is willing to fund your business. Alan Shugart, founder of Seagate (http://www.seagate.com/www/en-us/) and a few other disk drive companies, famously said "cash is more important than your mother." That's how important cash is and you never want to get into a situation where you run out of it.

The second line, short term investments, is basically additional cash. Most startups won't have this line item on their balance sheet. But when you are Google and are sitting on multiple billions of cash and short term investments, it makes sense to invest some of your cash in "short term instruments." Hopefully for Google and its shareholders, these investments are safe, liquid, and are at very minimal risk of loss.

Accounts Receivable

The next line is "accounts receivable," the total amount of money owed to the business for products and services that have been delivered but have not been collected. It's the money your customers owe your business. If this number gets really big relative to revenues (for example if it represents more than three months of revenues) then you know something is wrong with the business.

Total Current Assets

Total current assets is the amount of assets that you can turn into cash fairly quickly. It is often considered a measure of the "liquidity of the business."

The next set of assets is "long term assets" that cannot be turned into cash easily. Three examples are "long term investments," "property plant and equipment," and "goodwill," an intangible asset reflecting the strength of the brand, good relations with customers and employees, and proprietary systems and patents.

Liabilities

After cash, the liability section of the balance sheet is the most important section. It shows the businesses' debts. And the other thing that can put you out of business aside from running out of cash is inability to pay your debts. That is called bankruptcy. Of course, running out of cash is one reason you may not be able to pay your debts. But many companies go bankrupt with huge amounts of cash on their books. So it is critical to understand a company's debts.

The main current liabilities are accounts payable and accrued expenses. Both represent expenses of the business that have yet to be paid. Accounts payable are for bills the company receives from other businesses. Accrued expenses are accounting entries a company makes in anticipation of being billed. A good example of an accounts payable is a legal bill you have not paid. A good example of an accrued expense is employee benefits that you have not yet been billed for that you accrue for each month.

If you compare Current Liabilities to Current Assets, you'll get a sense of how tight a company is operating. Many companies operate with these numbers close to equal. They are sweating it.

Non-current liabilities are mostly long term debt of the business. The amount of debt is interesting for sure. If it is very large compared to the total assets of the business its a reason to be concerned. But its even more important to dig into the term of the long term debt and find out when it is coming due and other important factors. You won't find that on the balance sheet. You'll need to get the footnotes of the financial statements to do that. Again, we'll talk more about that in a future post on financial statement analysis.

Stockholder Equity

Stockholder Equity includes two categories of “equity.” The first is the amount that equity investors, from VCs to public shareholders, have invested in the business. The second is the amount of earnings that have been retained in the business over the years. Stockholder equity is also called the “book value” of the business.

The cool thing about a balance sheet is it has to balance out. Total Assets must equal Total Liabilities plus Stockholders Equity.

In summary, the Balance Sheet shows the value of all the capital that a business has built up over the years. The most important numbers in it are cash and liabilities. Always pay attention to those numbers. I almost never look at a profit and loss statement without also looking at a balance sheet. They really should be considered together as they are two sides of the same coin.

XI.

Chapter 11: Accounting: Part 3

The Cash Flow Statement

Cash flow is really easy to calculate.

The cash flow statement is a report of the changes in all of the accounts (income/expense and asset/liability) in order to determine how much cash the business is producing or consuming over a certain period of time (month and year being the most common).

Cash flow is the amount of cash your business either produces or consumes in a given period, typically a month, quarter, or year. You might think that is the same as the profit of the business, but that is not correct for a bunch of reasons.

The profit of a business is the difference between revenues and expenses. If revenues are greater than expenses, your business is producing a profit. If expenses are greater than revenues, your business is producing a loss.

But there are many examples of profitable businesses that consume cash. And there are also examples of unprofitable businesses that produce cash, at least for a period of time.

Production And Consumption Of Cash

Revenues are recognized as they are earned, not necessarily when they are collected. And expenses are recognized as they are incurred, not necessarily when they are paid for. Also, some things you might think of as expenses of a business, like buying servers, are actually posted to the Balance Sheet as property of the business and then depreciated (i.e., expensed) over time.

So if you have a business with significant hardware requirements, like a hosting business for example, you might be generating a profit on paper but the cash outlays you are making to buy servers may mean your business is cash flow negative.

Another example in the opposite direction would be a software as a service business where your company gets paid a year in advance for your software subscription revenues. You collect the revenue upfront but recognize it over the course of the year. So in the month you collect the revenue from a big customer, you might be cash flow positive, but your Income Statement would show the business operating at a loss.

Calculating Cash Flow

Cash flow is really easy to calculate. It’s the difference between your cash balance at the start of whatever period you are measuring and the end of that period. Let’s say you start the year with $1mm in cash and end the year with $2mm in cash. Your cash flow for the year is positive by $1mm. If you start the year with $1mm in cash and end the year with no cash, your cash flow for the year is negative by $1mm.

But as you might imagine the accounting version of the cash flow statement is not that simple. Instead of getting into the standard form, which as I said I don’t really like, let’s talk about a simpler form that gets you to mostly the same place.

Simple Form Of Cash Flow Statement

Let's say you want to do a cash flow statement for the past year. You start with your Net Income number from your Income Statement for the year. Let's say that number is $1mm of positive net income.

Then you look at your Balance Sheet from the prior year and the current year. Look at the Current Assets (less cash) at the start of the year and the Current Assets (less cash) at the end of the year. If they have gone up, let's say by $500,000, then you subtract that number from your Net Income. The reason you subtract the number is your business used some of your cash to increase its current assets. One typical reason for that is your Accounts Receivable went up because your customers are taking longer to pay you.

Then look at your Non-Current Assets at the start of the year and the end of the year. If they have gone up, let's say by $500k, then you also subtract that number from your Net Income. The reason is your business used some of your cash to increase its Non-Current Assets, most likely Property, Plant, and Equipment (like servers).

At this point, halfway through this simplified cash flow statement, your business that had a Net Income of $1mm produced no cash because $500k of it went to current assets and $500k of it went to non-current assets.

Figuring Liabilities into the Cash Flow Statement

Liabilities work the other way. If they go up, you add the number to Net Income. Let's start with Current Liabilities such as Accounts Payable (money you owe your suppliers, etc). If that number goes up by $250k over the course of the year, you are effectively using your suppliers to finance your business. Another reason current liabilities could go up is Deferred Revenue went up. That would mean you are effectively using your customers to finance your business (like that software as a service example earlier on in this post).

Then look at Long Term Liabilities. Let's say they went up by $500k because you borrowed $500k from the bank to purchase the servers that caused your Non-Current Assets to go up by $500k. So add that $500k to Net Income as well.

Figuring Stockholder Equity into the Cash Flow Statement

Now, the simplified cash flow statement is showing $750k of positive cash flow. But we have one more section of the Balance Sheet to deal with, Stockholders Equity. For Stockholders Equity, you need to back out the current year's net income because we started with that. Once you do that, the main reason Stockholders Equity would go up would be an equity raise. Let's say you raised $1mm of venture capital during the year and so Stockholder's Equity went up by $1mm. You'd add that $1mm to Net Income as well.

Finalizing the Cash Flow Statement

So, that's basically it. You start with $1mm of Net Income, subtract $500k of increased current assets, subtract $500k of increased non-current assets, add $250k of increased current liabilities, add $500k of increased long-term liabilities, and add $1mm of increased stockholders equity, and you get positive cash flow of $1.75mm.

It's simply not enough to look at the Income Statement and the Balance Sheet. You need to understand the third piece of the puzzle to see the business in its entirety. When you are doing projections for future years, I encourage management teams to project the income statement first, then the cash flow statement, and then end up with the balance sheet.

XII.

Chapter 12: Key Business Metrics

Defining A Set Of Metrics

The management team should spend time talking about and selecting the key business metrics to focus on.

Every business should have a set of metrics that it tracks on a regular basis. These metrics could include accounting issues like cash, revenues, profits, etc., but it should not be limited to those kinds of metrics.

As the business grows and develops, the amount of data you can collect and publish to your team grows. If you aren't careful, you can overwhelm your team with data.

It becomes very important to distill the business down to a handful of key business metrics. **There are usually four to six metrics** that will determine the overall health and growth trajectory of the business.

Potential metrics include:

Pre-Launch/Early Stage:

- Development resources
- Features completed
- Known bugs

Post-Launch:

- Customers
- Daily active users
- Churn
- Conversions from free trial to paid customer

Examples Of Metrics To Follow

Our portfolio company Meetup (http://www.meetup.com/) has learned to focus on successful Meetup groups. Those are Meetup groups that are active, meeting regularly, have growing memberships, and are paying fees to the company. Meetup can focus on other data sets like monthly unique visitors, new Meetup groups, total registered users, revenues, profits, and cash. They collect that data and share it with the team. But the number one thing they look at it successful Meetup groups and that has worked well for them. It is their key business metric.

Sometimes the most important data on your business is the hardest to collect. Twitter (https://twitter.com/) knows that the total number of times all tweets have been viewed each day, month, or year is a critical measure of the overall reach of the network. But because so many of those tweets are viewed on third party services, web pages, apps, etc, it is very hard to collect that data. The company is only now starting to measure them.

Most key business metrics will be drivers of revenues and growth but not all of them. Etsy (http://www.etsy.com/) is focusing a lot of effort on its customer service metrics, which are a cost center not a revenue driver. But the company knows that customer service is critical to the health of the marketplace, so customer service metrics are key business metrics for them.

Communicating Metrics Within Your Company

The management team should spend time talking about and selecting the key business metrics to focus on. They should collect the data on a regular basis, the more real-time the better in my opinion, and they should publish the key business metrics to the entire team.

I do not believe it makes any sense to segment who gets to see what business metrics in a company. Sales metrics should be shared with development. Customer service metrics should be shared with finance. And so on and so forth.

Some companies buy big screens and mount them on the walls around the office and publish the key business metrics on them so everyone can see them. I like that approach. But I also like sending out a regular email to the entire company with the key business metrics and how they are trending. And of course, I think these metrics should be shared with the Board and key investors.

When you publish financial projections (a topic for the coming weeks), you should include your projections or assumptions for key business metrics in the periods for which you are projection financial performance. Many of these metrics will be drivers of your projections but they are also helpful to establish the overall progress of the business over time.

Revising And Tracking Metrics

It is a good idea to evaluate what your company's key business metrics should be from time to time. I like to suggest at least once a year, probably around the annual budgeting exercise (another topic for the coming week). It is expected that you will change some of these metrics every year as the business grows and develops. Don't just keep adding new ones; you should also subtract old ones that don't seem as useful anymore. Keep the total number of key business metrics you are tracking to a small enough number that most people on the team could recite them from memory. Less is more when it comes to key business metrics.

Tracking key business metrics is important for many reasons, but probably the most important reason is cultural. It helps to keep everyone on the same page, aligns people across the different parts of the business, and leads to a culture of success when you see the key business metrics moving in the right direction. It's critical to celebrate when a key business metrics reaches a new and important milestone. These kinds of things seem silly to some but are incredibly important to building a strong company culture that can work together and grow rapidly.

XIII.

Chapter 14: Selling Your Company

The Exit Plan

A protracted sale transaction can be very harmful to the business and its stakeholders.

The exit plan. It typically means selling your company. The key issues for you, your investors, and your board to consider are:

- Price
- Consideration
- Reps, Warranties, and Escrow
- Integration plan
- Stay packages
- Governmental approvals
- Breakup fees
- Timing

Price is the amount the buyer will pay for the business. It is the most important issue and also the simplest.

Consideration is the mechanism the buyer will use to deliver the purchase price. The simplest form of consideration is cash in your local currency. That is also the most common form of consideration. Another common form of consideration is the acquirer's stock. That could be publicly traded liquid stock or it could be illiquid private company stock. Buyers can also pay with debt obligations, earn out plans, and a host of other esoteric and less common forms of consideration.

Reps and Warranties are the legal promises and obligations you will take on as a seller. A portion of the purchase price is usually held back and escrowed for some period of time to backstop the reps and warranties. **The escrow** is usually a percentage of the purchase price. Ten percent is common but I've seen as little as 5% and as high as 25%.

The integration plan is the way the buyer plans to operate your business post acquisition. Many sellers don't think this matters too much but I think it is critical. If you think about the interests of all the stakeholders in the business, not just the shareholders, then the integration plan becomes a very important part of the overall deal.

Stay packages are compensation plans put together by the buyer for your team. There may even be a stay package for you if the buyer wants you to stick around and most of the time they should. These packages are a combination of cash and stock that vests over a stay period. It is common that some of the consideration may be applied to stay packages, particularly unvested employee stock in your company.

Government approvals involve requirements by the government, and not just your country's government, to approve the sale. This is not common for small deals. Anything sub $100mm would be very unlikely to require governmental approvals. Really big deals, like billion-dollar plus transactions, often run into these issues. Powerful companies that the government worries may have monopolistic properties will usually face governmental approvals for their acquisitions.

Breakup fees are what the buyer may have to pay if your business will face negative consequences if the sale is announced and then does not close. Most buyers will resist agreeing to breakup fees but they do exist in many deals, particularly very large deals.

Timing is another important issue that many sellers don't focus on. Sale transactions are very distracting for the senior team and often for the entire team. A protracted sale transaction can be very harmful to the business and its stakeholders. You can put time commitments into the letter of intent to sell the company and you can expect the buyer to live up to them.

XIV.

Chapter 15: M&A Fundamentals

Mergers & Acquisitions

Acquisitions are much more common and much better.

As the term M&A suggests, there are two types of deals, mergers and acquisitions. Acquisitions are more common; it is when one company is taking control of the other. A merger is when two like-sized businesses combine. An example of a merger is the AOL/Time Warner business combination ten years ago. I am not a fan of mergers. I believe it is way better when one company is taking control of the other. At least then you know who is in charge. Mergers are very complicated to pull off organizationally.

I have done a few mergers in the startup world. The best example is Return Path and Veripost which merged in 2002. The two companies started at about the same time, both got venture funding, and built almost identical businesses. They were beating each other up in the market and getting nowhere quickly. The management teams knew each other and the VCs (Brad Feld and yours truly) knew each other. We finally decided to put the two companies together in a merger. It worked because we decided that Return Path's CEO would run the combined companies and because Veripost's CEO was fully supportive of that decision. Even so, it was not easy to execute.

Acquisitions are much more common and I believe much better. Most of the deals you can think of in startup-land are acquisitions. A larger company is acquiring a smaller company and taking control of it.

Consideration: Cash Vs. Stock

The next distinction that matters a lot is how the consideration is paid. The most common forms of payment are cash and stock. In fact, you'll often hear corporate development people say "it's a stock deal" or "it's a cash deal." Companies can pay with other consideration as well. Debt is sometimes used as consideration, for example. But in startup-land, you'll mostly see stock and cash.

Most people think cash is preferable. If you are selling your company, you want to know how much you are getting for it. And with cash, that is clear as crystal. With stock you are simply trading stock in your own company, which you control, for stock in someone else's company, which you don't control.

However, over the years in maybe a hundred deals now I have made more money in stock-based deals with the acquirer's stock than I have lost in acquirer's stock. I don't know if that is just my good fortune or not. But I certainly have had the experience of taking stock in an acquisition and having that stock crumble and lose it all. So if you are doing a stock-based deal, make sure you do your homework on the company and its stock.

Buying Assets Or The Entire Business

Typically the purchaser can either buy assets or buy the company (via its stock). If you are selling your company, you'll generally want to sell the entire company and thus all of its stock to the buyer. The buyer may not want to entire company and may suggest that it wants to do an "asset deal" which means it cherry picks what it wants and leaves you holding the bag on the unwanted assets and some or all of the liabilities.

For obvious reasons, fire sales are often done as asset deals. Healthy companies with bright futures are not often purchased in asset deals. They almost always sell the entire company in a stock deal. If you are selling your company you should try very hard to do a stock deal for the entire company.

For more information on M&A, visit this blog posts:

Case Studies

M&A Case Studies: ChiliSoft

http://mba-mondays.pandamian.com/ma-case-studies-chilisoft/

M&A Case Studies: WhatCounts

http://mba-mondays.pandamian.com/ma-case-studies-whatcounts/

M&A Case Studies: WhatCounts Sales Process

http://mba-mondays.pandamian.com/ma-case-studies-whatcounts-sale-process/

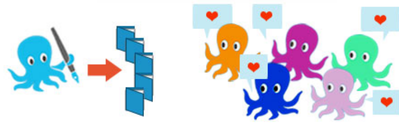
M&A Case Studies: Feedburner

http://mba-mondays.pandamian.com/ma-case-studies-feedburner/

M&A Issues: The Integration Plan

http://mba-mondays.pandamian.com/ma-issues-the-integration-plan/

Which Friends Will Receive Your Gift?



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