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Looking to the future — start-up businesses

Don’t forget the accounting!

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Starting a new business?

Starting a new business is both exciting and challenging. Don’t derail your progress by negotiating contracts without considering the accounting outcomes which can be unexpected and in some cases unwelcome! Consideration of the accounting outcomes in negotiating contracts can save a lot of angst in future years.

Start-ups face interesting challenges, not least of which is getting enough cash and other resources to get the business off the ground with the appropriate infrastructure, further investment to develop the company’s products and to market the company’s products to potential customers and offshore markets. Start-up companies often find themselves entering into arrangements with investors, employees and suppliers that are unusual and give rise to some unexpected accounting outcomes.

Key areas to be aware of for start-ups include:

- Selecting the appropriate financial reporting framework
- Debt/equity raising
- Employee share schemes
- Paying contractors and other suppliers using shares
- Business acquisitions with earn out clauses where the vendors are subsequently employed in the business
- Revenue recognition
- Development of intellectual property
- Going concern.

Selecting the appropriate financial reporting framework

If you are looking for funding to progress the business, explaining your financial performance and financial position to potential investors and financiers can be key.

As a minimum, companies and certain other entities are required to comply with the Inland Revenue Department's minimum financial reporting requirements. These are found in the Tax Administration (Financial Statements) Order 2014 ('Tax Order'). The requirements in the Tax Order are fairly basic and do not cover in detail the accounting policies or format to be used so you have some scope to determine how to prepare your financial statements provided these minimum requirements are met.

Depending on the size of the entity, the number of shareholders and whether shareholders wish to 'opt in', you may be required by the Companies Act 1993 (or other legislation if not a company) to prepare financial statements in accordance with generally accepted accounting practice (GAAP). Further information on the legal framework for financial reporting can be found in Deloitte publication *The New Zealand legislative environment and related financial reporting requirements.*

In the early years where the business is small and closely held, if GAAP financial statements are not required by law, simple special purpose financial statements that meet the requirements of the Tax Order may be sufficient for the company's needs.

As the business starts to expand and has more substantial capital requirements, an internationally recognised GAAP framework such as New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS) may be more appropriate.

Institutional and offshore investors in particular will often be keen to see NZ IFRS/IFRS financial statements. If you are looking to raise capital through an initial public offering it is useful to have a history of financial performance and position using a consistent framework so investors can easily see trends.

Even if you choose to use a special purpose framework in the early years, consideration of the terms of contracts that will span several years may be important if you think you will need to move to NZ IFRS in the future.

Going concern

Given most start-ups have to continue to raise equity and debt funding as they grow, directors will likely need to regularly assess whether the company is a going concern. The board will need proper support for the analysis including cash flow forecasts and disclosure of any material uncertainties may need to be made in the financial statements.

Some key questions for directors to consider include:

- Has a cash flow forecast been prepared covering at least twelve months from the expected date of approval of the financial statements if the entity is audited? Does this forecast indicate that there is sufficient liquidity taking into account existing and expected funding arrangements?
- Does the entity have sufficient access to funding to cover current commitments and possible contingent liabilities?
- Has an analysis been performed to ensure that the terms of current funding arrangements are being met? If covenants have been breached, have discussions taken place with the funder to secure waivers where possible?
- If funding lines are due to expire within the year, will the entity be able to secure new funding or renew existing funding arrangements?

Debt/equity raising

Often angel or private equity investors may require unusual funding arrangements which can have surprising accounting consequences (e.g. a hurdle return rate before the original shareholders get their returns, mandatory dividends, repayment after a certain time frame if the business hasn't been successfully floated). What looks like equity (e.g. preference shares) may in fact be debt under NZ IFRS. Quite seemingly innocuous terms can lead to debt classification and in some cases 'embedded derivatives' which must be revalued through the income statement and which can cause significant volatility. In some extreme cases, changes in the value of the company's shares may be required to be recognised in the income statement.

If you are considering issuing any instrument that is not just an ordinary share, scrutiny of the accounting outcomes is advised.

Employee share schemes

Start-ups that want the best talent and want to incentive their staff but don't necessarily have the cash to do it, may do so through issuing shares. Under NZ IFRS, payment in shares is required to be recognised in the income statement. The expense is measured using the fair value of the shares. If the value of the company is increasing rapidly, this can lead to significant expense and volatility in the income statement.

Accounting for share schemes is complex and depending on the terms can have very different outcomes. While accounting should never drive the commercial aspects of a transaction, it can be important to consider if there are acceptable alternatives to achieve the same commercial imperatives while managing the accounting consequences.

Payment for other goods or services in shares can give rise to similar accounting challenges. Again, considering the accounting outcomes when negotiating contracts is key.

The tax treatment for employee share schemes should also be considered when determining the terms of the arrangement to ensure there aren't adverse outcomes for the company and/or the employees especially in respect of the timing of tax payments.

Business acquisitions with earn out clauses where the vendors are subsequently employed in the business

When a business is acquired and there is both an earn-out clause and some or all of the vendors are subsequently employed in the business, this can give rise to complexity. It is very likely that the earn-out payments for the former vendor(s) who continue to work in the business may have to be treated as employee remuneration (or share based payments if the earn out is for shares) and expensed in the income statement. These payments can be substantial if the business is successful and can add volatility to the income statement. Careful consideration should be given to the commercial terms of the arrangement.

Development of intellectual property

Often start-ups are developing original intellectual property. NZ IFRS has specific rules regarding when the expenditure should be expensed and when it should be capitalised. Attention will need to be given to whether the criteria to capitalise have been met. Amortisation methods and useful lives will also need to be determined. Where development costs are capitalised, assets will need to be assessed for impairment and impairment models may need to be developed.

Revenue recognition

Revenue recognition under NZ IFRS is a complex area and early attention to the terms of contracts with customers can be helpful in managing the accounting outcomes especially if the contracts are long term. Bundled services (e.g. sale of software, upgrades and support) are especially challenging.

How we can help

We have an experienced team of professionals who can assist you with the challenges of starting up a business including:

- Core accounting and tax advisory services
- Planning and setting up a value adding finance function and business processes
- Board level advisory, reporting and virtual accounting services
- Financial modelling, capital raising and valuation services and support.

Ask your Deloitte advisor for our other 'Looking to' publications which cover some of these topics in more detail.

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