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A Consultant's View The Needs of a High-Tech Start-Up

by ROCCO A. LATERZO / *Director of Audit Operations, Boston*

High-technology start-up companies are the most intriguing of ventures today. It is not unusual to see a company develop in three to five years from a dream or a product prototype to a publicly held multimillion-dollar revenue company.

During this period, the company is continually concerned with systems, accounting, financial, or SEC-related matters. The demands created on the company as a result are significant. Too often, the founders of the new entity do not pay sufficient attention to these matters; and when they do, they find the changes required are costly and inefficient.

The most opportune time to plan and develop basic strategy is when the company has the most flexibility, which is at the point when it is being created. Many

entrepreneurs are beginning to recognize the importance of obtaining strong professional expertise as one of the first steps in forming the new venture.

The types of financial, accounting, and tax concerns for a given company vary significantly. The need really depends upon the objectives and expertise of the entrepreneur. There are, however, common elements in each new entity.

Tax Structure

One of the first issues that concerns the entrepreneur is the tax structure of the new entity. Many entities are organized as regular taxable corporations. Others elect Subchapter S status or are formed as partnerships. The latter forms are used to provide the owners immediate tax benefit from the start-up losses that may be incurred by the company. Such entities are converted to corporations when earnings commence. The most

obvious disadvantage of corporations or partnerships is the lack of the loss carry-forwards for use in the corporation's future years, when earnings are being generated. Twelve start-ups I have been involved with in the past two years have required equity from sources outside of the founders; of these, two-thirds initially selected the corporate form.

Research and development partnerships are also used at times—normally influencing those stages after the initial start-up. This is done to fund specific activities of high-technology companies, generally in such a way that the research and development costs do not appear in the company's financial statements. Such partnerships act as tax shelters for the partners. Further, though the agreements often contain equity incentives in the

high-tech company, they can also be structured in such a manner that equity incentive is not given, thus preventing stock dilution to founders of the company. The general approach, once a product or process is developed, is to license or sell on an exclusive basis back to the company for royalty payments and/or equity.

The accounting and tax rules which must be followed to allow for the offering of an R&D partnership are highly complex, and adherence to the intricate requirements must be carefully monitored. Each of these entities is under constant scrutiny and challenge by such authorities as the IRS, the SEC, and the FASB. However, it provides enormous benefits. The recent popularity of the research and development partnership is demonstrated by an article in the April 18 issue of *Business Week*, which states that over \$200 million was recently raised through such entities for the biotechnology industry.

A number of start-ups quickly find themselves in an export mode. Once earnings are generated, a Domestic International Sales Company (DISC) is often needed to take advantage of present tax laws, which allow unremitted earnings of the DISC to remain untaxed until dividend to its domestic parent.

Business Plans

Time and again, the entrepreneur is told of the importance of a strong business plan—one that not only achieves the objectives of properly planning the future direction of the company but also effectively markets the company to potential outside investors. The entrepreneur may understand this but may not have the skills necessary to take the concept and effectively put it into a formal plan. The assistance of experienced professional advisors in developing a plan can be the difference between obtaining or not obtaining investors. They can provide valuable independent challenges to all aspects of the plan prior to its being submitted to outsiders. These challenges, if properly responded to, will produce both a better plan and

an entrepreneur who is better able to respond to the questions put forth by such individuals as venture capitalists.

The professional accountant can be particularly helpful in preparing financial projections for the plan. This will pull together all aspects of the total plan, including the estimated cost of starting the venture; the manufacturing, marketing, and administrative costs at various levels of activity; the revenue to be generated; and the financing needed to get the venture through its first five years. While the outside accountant is often asked to prepare this part of the plan, better results are usually achieved if the financial plan is developed by the founders of the venture and then challenged by their accountant. It is my belief that the founders, who often lack a strong financial background, are better able to defend the financial parts of the plan to potential investors if they have written it.

Systems Development

A good management information system with strong internal control is another basic requirement for a start-up's successful growth. Yet, there are too many times when systems are not adequately addressed and major breakdowns occur, causing serious, sometimes fatal, problems. A first step in preventing this is achieved through proper planning and the up-front allocation of resources, both personnel and financial, to systems development. A second step is constant monitoring of the system, with the external annual audit being an important ingredient of the process.

The typical venture uses a manual system in the stage prior to manufacturing the product. Once manufacturing and selling start, the system is generally converted to either a time-sharing or microcomputer system. The time-sharing systems seem to be

able to support a company's growth for most of its first five years. The last step in the process is the establishment of an in-house computer facility. The evolution of the system requires serious planning, as well as advice from experts in systems development.

Accounting and Tax Principles

One must adopt accounting and tax principles that are appropriate for the objectives of the firm. Different objectives call for significant differences in application. Further, once such principles are established, they are very difficult to change. Tax principles should be established which defer taxation and thus improve cash flow. The financial reporting policies must produce meaningful financial information and facilitate investor acceptance.

The most fundamental difference affects the basic accounting method to be used. While the accrual method of accounting is a primary tenet in financial reporting, under certain circumstances companies have the opportunity to use methods that are more advantageous for tax purposes. Examples are the cash, hybrid (a combination of accrual and cash methods) or dual (use of one method for one trade or business and another for a dissimilar trade or business) installment, and completed-contract methods. A recent illustration concerns a manufacturer and distributor of computer educational games, where the manufacturing entity is on the accrual method while the marketing, planning, and financial arm of the business, incorporated as a parent of the manufacturing entity, uses the cash method. Several recent computer start-up companies have elected the installment method of reporting sales for tax purposes, thus deferring the recognition of a portion of their profits on these sales. In order for a company to utilize the installment method, it must offer its customers the right to make payments in at least two install-

ments. Recent changes in the tax law make it easier to adopt this method.

Possibly the most complex accounting principle concerns revenue recognition. High-technology companies generally market products of a type and in a manner which require a more well-defined policy than the simple rule of recognizing revenue when shipment takes place. Transactions have to be carefully scrutinized because of such matters as right-of-return and lease-versus-sales issues. Further complications occur because many companies deal in long-term projects, which may require revenue being recognized in a manner that is consistent with the project's stage of progress—otherwise known as the percentage of completion method. This method of revenue recognition relies heavily on an estimating process which requires more subjectivity than most other accounting principles. Tax principles governing revenue recognition most often differ from

accounting in long-term projects, where the completed-contract method is generally used for tax purposes, and in leasing, where operating leases are generally used for tax purposes.

Policies governing the proper matching of warranty costs to revenue and inventory valuation and obsolescence are the next most difficult to formulate. However, other significant areas are frequently not considered, and yet they are most important. These include policies on property, plant, and equipment capitalization and depreciation, intangible capitalization, such as that concerning purchased computer software costs, compensated absences, and tax effects on unremitted earnings.

The following two examples illustrate how proper planning produced tangible benefits.

■ A company had yet to establish a policy for capitalizing or expensing the mold it was developing for a new product. Management believed the mold should be capitalized and amortized over a three-year period, yet it was concerned that such capitalization would result in loss of the research and experimentation credit for tax purposes.

The matter was resolved by adopting a policy of capitalizing the molds for financial reporting purposes and expensing the molds for tax purposes.

■ A company established a DISC upon its entry into an international market. Initially, the company thought it should provide tax on unremitted DISC earnings for financial reporting purposes. No tax effect was required, however, after determining that the earnings were going to be used to finance future international operations, and thus were to remain unremitted for an indefinite period.

Summary

The successful entrepreneur understands that the pressures on his venture will increase as it grows, that he must have his financial and accounting matters in order so he can properly attend to the major concerns he faces—the successful development and marketing of his product. ▲

FORECAST/Microcomputers

By its very nature, high technology's most spectacular achievements leap up out of nowhere and therefore defy prediction. So let me stay on home ground and talk about microcomputers and the impact they will have on the office worker by 1990. □ Microcomputers are getting smaller, cheaper, and easier to use. Soon they will be cheap enough to be selling like typewriters, and will be an indispensable part of everyone's job. Even in the home the typewriter will be gone, replaced by the microcomputer word processor. □ The impact of microcomputers in the work place will be awesome. It will change the entire nature of the office, the office worker, and job profiles. Relatively unskilled or mentally undemanding jobs will disappear. Only office workers with excellent dictating skills will find it faster to have text prepared by someone else, rather than handle the job themselves. Filing? As we reach a "critical mass" of computers in the office, paper records and filing will disappear at an alarming rate. The microcomputer will also replace junior accountants, and senior staff will understand the data so much better for having prepared it themselves.

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