CHAPTER 11

Doing an Internal Review of Your Business

"My problem lies in reconciling my gross habits with my net income."
Errol Flynn

VCs conduct a thorough investigation of your business before they put their money in it. This audit or investigation is referred to as due diligence. It entails reviewing various aspects of your company, such as its business potential and prospects, its tangible and intangible assets, financial records, systems, procedures and policies, etc. For the VC it is important to review as detailed a level of information as possible in order to uncover potential problems. The "exposure areas", or issues entailing risks, uncovered by the due diligence allow the VC to assess the risk of investing in your venture and adjust or validate his returns expectation from his investment.

The VC expects your business to be clean, that is, there should be no exposure to risks other than the ones that you have already identified and communicated to the VC in your business plan. As a part of the process of getting yourself and your business ready for venture capital, you should initiate an internal review of your business, which may be conducted by your chartered accountant under the overall guidance of the VC intermediary.

This review would be in the nature of, and similar to, the due diligence that a VC would conduct after signing the term sheet. The object of this review, which may also be called "pre-due diligence", is to identify and defuse issues that might lead to the VC refusing to invest in your business.

Thus, a review should be done of the following areas:

- Ownership issues;
- Employment agreements of the founders;
- Employee issues;
- ESOP — employees stock option plan;
- Intellectual property rights (IPRs);
- Minutes of Board meetings and Shareholder meetings;
- Record keeping;
- Tax review and compliance;
- Litigation and contingent liabilities; and
- Risk management and insurance.

Ownership Issues

Most privately owned business, especially if they do not have independent or institutional investors, tend to be run and managed like sole proprietorships. The business belongs to the owner who also manages it full time. He may have some key employees whom he relies on for operating management.

In case of businesses owned by more than one owner, the business entity is usually a privately limited company, and the respective portion of ownership of each owner is effected by issuing appropriate number of company shares to each owner, who is called the shareholder. The legal relationships between the shareholders *inter se*, and between them and the company are guided by the Memorandum of Association ("Mem") and Articles of Association ("Art") of the company, which are also called the bye-laws of the company. The "Mem & Arts" are the constitution of the company and define what the company can do, procedures for making decisions, the relationship of the company with the directors on the board of the company, etc.

The VC would like to ensure that:

- There is clarity about who owns what percentage of the company;
- The ownership is legally enforceable and is duly represented by paperwork which is complete in all respects.

The VC's requirements relating to ownership issues are listed below:

- There should be a complete audit trail of all the shares issued or transferred.
- All share issues and transfers should have been done in conformance with existing laws. All the filings with the Registrar of Companies should have been done within the specified time frames.
- The minutes of board meetings and shareholder meetings that have effected the issuance or transfer or transmission of shares should be kept properly. Equally, other papers, such as the meeting notices, and attendance and voting record of the directors and shareholders, etc. should be in order.
- If there is a shareholders' agreement among the shareholders then there should be no conflict between the provisions of the articles of association and those of the shareholder's agreement.
- There is clarity about the conditions which may trigger automatic share transfers, for example, in case of death or disability, etc.
- That the restrictions on share transfers are normal and reasonable and do not trigger any automatic sale of shares.
- There is no absentee or departing founder who is still holding shares.
- The statutory register for share transfers is up-to-date and complete in all respects.
- There are no shareholding related disputes.
- All shareholders unanimously agree in principle that shares should be issued to the VC for raising money to finance the business.

Some companies have complicated ownership structures in which there are many corporate shareholders with cross holdings. Such companies would find it difficult to raise VC funding as VCs prefer simple ownership relationships as there are fever chances of conflicts.

Employment Agreements of the Founders

In owner managed businesses, there is a tendency to have unwritten and informal arrangement regarding the compensation that founders would be paid for their role as managers of the business. Payments to them are made on an *ad hoc* basis, depending on the cash availability in the business. As they are the owners of the business and primarily responsible for its funding, they feel that there is no difference between the cash lying in the company's bank account and that in their personal bank account. Moreover, they fail to observe the distinction in personal and business expenses. Indeed, there is a general tendency to pass off personal expenses as those incurred for the running of the business.

There exists in most owner managed businesses an owner's current account to which all advances taken by him are debited. More often than not, this account is not reconciled for a long time as the owners conveniently fail to provide details of the expenses for which these advances have been taken.

Some family members of the owners may also be shown as employees and may be paid salaries for roles that they may not be performing in reality. Not only is such an arrangement risky for the business from the point of view of income tax authorities, it also indicates a certain lack of integrity to the outside investor, such as the VC.

You must sort out these issues before the VC commences the diligence of your business. In particular, do ensure the following for improving your chances of closing a VC deal:

- Sign employment contracts for all owners and family members who are genuinely employed in the business.
- Remove from payroll any family members who do not perform any functions in the business.
- Define the roles, responsibilities and the designation of the owner and all related parties employed in the business.
- Reconcile and close all owner and related current accounts in the books of account.
- Clearly distinguish between personal and business related payments and ensure that in no case are personal expenses of the owners and related parties charged off as business expenses.