A Special Report…

Capitalization Tables

What they are and why they are important

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Capitalization Tables: What they are and why they are important

A note to the reader: *Those of you who are familiar with Cap Tables will find the "Do's and Don'ts" section of this report the most valuable.*

What is a Capitalization Table?

Commonly referred to as a Cap Table, this document lists all the shares that your company has committed to others—including shares that have been gifted, promised, and accrued. The Cap Table also includes options issued and restricted stock. It reflects the value of each share of stock during each round of funding and the percentage of ownership held by each investor.

Why is a Cap Table necessary?

A Cap Table is an important tool. At a minimum, it allows a company to keep track of its shareholders. It is also used for analyzing the founders' and investors' percentage of ownership and equity dilution. It enables an extrapolation to determine the optimal number of rounds of funding and the level of investment required to support its exit strategy via acquisition and an Initial Public Offering (IPO).

When a company raises money, either as a startup or mature entity that needs capital to expand, everyone who provides funding becomes a shareholder through stock, warrants, convertible notes, or options. Each shareholder's contribution must be recorded properly, within the rule of law.

It is important to emphasize that even start-up companies have financial reporting responsibilities and must create a Cap Table.

How is a Cap Table created?

Initially, a Cap Table can be created in an Excel spreadsheet. An Excel-based table is fine as long as your sources of capital are limited to family and friends. However, as you involve more investors and grant stock options to employees, we recommend migrating the spreadsheet data to software specifically designed for the purpose. Doing this will enable you to audit your Cap Table, run the necessary financial reports and avoid costly mistakes.

Why is a complete, accurate, up-to-date Cap Table so important?

- It shows prospective investors who owns the company.

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- It identifies major shareholders.
- It identifies those who make and influence the decisions.
- It prevents unpleasant surprises. *Example:* When your company is ready to be sold or to go public, you will be able to protect yourself from the long-lost relative who surfaces, claiming that Joe promised him 10,000 shares 5 years ago.
- It gives your company credibility.

It allows the company to track and audit shareholder documentation and securities law compliance.

The Do's and Don'ts

These "do's and don'ts" apply equally to public or privately-held companies that plan to go public, merge, or be acquired.

Do:

- Consult with professionals such as attorneys, CPAs, and consultants who specialize in equity compensation issues, before beginning the process or either raising capital or issuing stock options or other forms of equity grants.
- Incorporate in the appropriate jurisdiction. (Delaware is the preferred state, but with the forces of globalization offshore entities are gaining in popularity) .
- Make sure that you have proper paperwork for the business and for raising capital. Professional guidance in this area is critical.
- Keep your paperwork organized. Paperwork includes board minutes, signed investor paperwork, the stock ledger, stock option plans, and employee grants.
- Create a plan to communicate with your investors on a monthly or, at a minimum, quarterly.

Don't

Avoid the following costly mistakes:

- Make sure that your Cap Table is as simple as possible. It should be easy to read and understand.

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- Do not attempt to manage the capital-raising / equity compensation process on your own. Not only is it complex, the consequences of errors can include jail time.
- Do not turn the responsibility for maintaining the Cap Table over to someone else without clearly delineating what they are responsible for and what you will continue to handle. Ultimately, the primary owner / founder are responsible for all aspects of the business.
- Do not accept checks without properly prepared and signed paperwork—even from family and friends.
- Do not solicit money from anyone you have not interviewed. You must talk to prospective investors to determine whether or not they are accredited and also understand the financial risk of investing in the company.
- Do not speak to potential investors who live outside the state in which your company is incorporated without first checking with your attorney.
- Do not use the Internet to solicit funds.
- Do not make verbal promises involving equity.
- Do not lose track of your shareholders. Make it clear that they must inform you of a change of address. “Losing”—not being able to locate—a shareholder has caused mergers and acquisitions to fall apart, significant delays in merger or IPO situations and resulted in the reduction of purchase prices. In at least one case, “losing” an investor caused a company to file for bankruptcy.
- Do not create a “quick and dirty” Cap Table with the intention of “fixing” it later. Profitable companies have been forced to file for bankruptcy protection and start all over because their Cap Tables were not correctly stated.

Summary

Protect yourself and your company from the severe penalties that can result from mishandling your Cap Table process.

Creating a Cap Table is relatively easy, but managing related paperwork and other issues can be costly, complex, and time-consuming. Simplify your life by documenting all investor-related information from the beginning.

Capitalization Tables: What they are and why they are important

An accurate, complete, and up-to-date Cap Table is an important, credibility-building document that provides a financial history of your company and tells investors that you take equity issues seriously.

For more information about Cap Tables, stock option plans, and other equity compensation matters, contact:

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