Center for the Study of Minority & Small Business

Department of Business Administration

Minority and Small Business Review

Volume 17

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Spring, 2019

Featured Articles

Economic Outlook for the Year of 2019

The new FASB Accounting Standards for Non-Profit Organizations

Start-Up Financing 101

Hype vs. Reality—AI Adoption for Small Businesses

Bridging The Management Gap: Tactical Strategies for Accessing Critical Expert Help for Your Small Business on Affordable & Flexible Terms

Role of Ethics in Corporate Governance

Minority and Small Business Review

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The Minority and Small Business Review is published annually each Spring by the Center for the Study of Minority and Small Business (CSMSB) and the Department of Business Administration at University of the West. This publication includes original contributions based on both theory and practical insights on a variety of topics on entrepreneurship. While the topics may vary, each volume contains articles on subject matters that are critical to the growth and sustainability of minority and small businesses, such as: leadership & management strategies; finance/accounting; access to capital; marketing/branding; and legal/tax issues. The contributing authors include UWest Business Department Faculty as well as industry experts, business leaders/executives and entrepreneurs. Each year, the Review seeks to provide information that is content-rich and topically current.

We invite such articles to be submitted to the Editor via e-mail to meskeremt@uwest.edu (using a standard MS word-processing program such as Word). All submissions are subject to editorial review and modification--acceptance is not guaranteed unless such notification is provided in writing by the Editor.

The annual subscription rate is $10.00 for mailing within USA and $15.00 outside USA. (Please see Order Form). All correspondence regarding contributors' writings, excerpt permission and scholarly exchange; as well as subscriptions, changes of address and request for sample copies, should be addressed to: Editor of The Review, CSMSB, University of the West, 1409 N. Walnut Grove Avenue, Rosemead, CA 91770.

Center for the Study of Minority and Small Business

The Center for the Study of Minority and Small Business (CSMSB) serves as a link between the University and the minority and small business community, offering regular seminars, lectures, conferences, business counseling and the publication of "The Review". The Center seeks to develop itself into an outreach link to connect area minority and small businesses with governmental and non-governmental organizations in order to broaden their exposure to current business realities and changing governmental regulations.

As the Center strives to strengthen its efforts to play a more meaningful role towards the long-term growth and sustainability of minority and small business, it is mindful of the fundamental need for a broad-based support and partnership of area stakeholders and the community at large.

Your subscription to The Review will not only provide us your contact info so we can advise you of upcoming programs and events, it will also signify your support to the Center's programs and activities.

We invite your ideas, feedback, support and involvement. Please address all correspondence to the Center's Director via email @ meskeremt@uwest.edu.

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Message from Dr. Otto Chang, President
University of the West

April 25, 2019

As the president of a university dedicated to serve the community, I am very proud of the annual publication of ***Minority and Small Business Review***. A product of our Center for the Study of Minority and Small Business, the Review is in its seventeenth year. The articles in the Review are aimed to help the small business of Southern California to make better and informed business decisions. The Review is edited by Professor Meskerem Tadesse and authored by UWest faculty members, noted scholars, and accomplished practitioners from our own backyard.

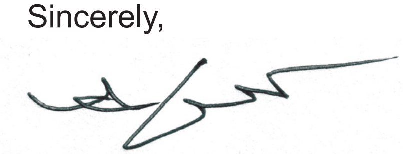
We at University of the West are committed to partner with entrepreneurs of our region to provide resources that will promote their continuing success and achievement. Small businesses are the backbone of our economy. They invest in our region, create jobs for our residents, generate local tax dollars, and contribute to the vibrancy of life in Southern California.

As part of our commitment to the local business community in the greater Los Angeles area, University of the West provides unique educational opportunities to a diverse population of outstanding students who are pursuing both graduate and undergraduate degrees to furthering their career goals and sharpening their leadership skills to benefit others.

My thanks to all who contributed to the 2019 edition of the ***Minority and Small Business Review*** and special thanks to Professor Meskerem Tadesse who serves as the Director of the Center and Editor of the Review.

I extend my best wishes for your continuing success.

Sincerely,



Dr. Otto Chang, President
University of the West

From The Editor

April 25, 2019

On behalf of the Business Administration Department of University of the West ("UWest"), I am happy to present to our readers this 17th Volume of the **UWest Minority and Small Business Review ("The REVIEW")**. This annual publication is hosted by the UWest Center for the Study of Minority and Small Business (CSMSB) each spring, containing a collection of business articles authored by faculty from UWest and other institutions, as well as industry experts, entrepreneurs and business leaders.

Given the large number of businesses serving and operating in the broader San Gabriel Valley, in which our institution resides and operates, this publication serves as a venue to extend our greetings to, as well as to inform and consult our community businesses and our readers at large, on current and relevant topics that impact our collective societal and economic interests. Each issue covers a variety of subject matters that are currently relevant. For example, this year's issue contains articles on such topics as the new FASB Accounting standards impacting non-profit organizations by one of our Accounting professors; insights into start-up financing by a seasoned securities and business law expert; and one on the economic outlook for 2019 by our university president.

As we continue to focus on and explore how best to optimize our local businesses, we invite your contribution of ideas, questions, articles and your partnerships in this worthwhile endeavor. Please address your communication directly to the Editor at meskeremt@uwest.edu.

Finally, we offer our sincere appreciation to our contributing authors who graciously provide their valuable works to share with our readers.

Best Regards,

Professor Meskerem Tadesse, Director
Center for Minority and Small Business (CSMSB) &
Editor, Minority and Small Business Review

ECONOMIC OUTLOOK FOR THE YEAR OF 2019

By Otto Chang, PhD
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Abstract

In the immediately past year of 2018, the US and world economy continued the longest economic recovery since its inception in June 2009, even though the stock market started to correct its upward ascending toward the end of the year. Will the economy continue to expand, or would there be a correction that will slow down or bring a recession in 2019? Are there major risks that will cloud the economic outlook in 2019? These are issues debated by economists. For the year of 2019, the consensus is that the economy will continue to grow, but the pace will slow down.

For the US economy, the positive economic growth is expected to continue through 2020. The tax cuts signed into law in late 2017 have helped to raise real disposable income and real personal spending. Business confidence is still high, translating into continuing investment spending and employment growth. Upbeat consumer confidence, record levels of household wealth, and high personal saving rate support continuing consumer spending. Inflation and interest rates remain relatively low. Government fiscal policies will remain expansionary in the coming year. Given this positive economic climate, US real GDP is expected to grow at 2.7 percent rate in 2019, compared with a growth rate of 2.9 percent in 2018 (Wells Fargo 2018). However, there are signs that things are slowing down. Some of the factors that have contributed to strong economic growth in 2018 are beginning to fade. The effects of the tax cuts will dissipate in 2019, which will lead to deceleration in real personal consumption expenditures. Growth in real government expenditures is also set to slow down. The Federal Reserve Bank may raise interest rates a couple of time in 2019. Higher interest rates will start to weigh on the housing market.

For the rest of the world, the economic growth is anticipated to continue in 2019 for several reasons. First, global industrial production is expected to maintain its pace as the commodity price has remained relatively stable. Second, expansionary macroeconomic policies will be maintained in many major foreign economies to stimulate global economic activity. Although global trade will be affected by the tariff war between US and China and the slower growth rates in advanced economies, but it will be offset by a pickup in the growth of emerging markets and developing economies. Based on these observations, the global economic expansion is expected to be at the rate of 3.7 percent in 2019 (IMF, 2018). The International Monetary Fund pointed out several intermediate downside risks that may hinder the world economy: Escalating trade tensions and the potential shift toward protectionism; a more rapid and sizable tightening of monetary policies in US and/or EU; potential problems in financial and local government debts in China; rollbacks of the financial regulations; cybersecurity breaches and cyberattacks; and other noneconomic factors such as geopolitical conflicts, extreme weather events, and terrorism.

OUTLOOK FOR THE U.S. ECONOMY

Given an economic climate with some mixed signs, the U.S. economy is expected to grow at a slower pace in 2019, than in 2018. For the year ahead, federal spending will grow, particularly in defense spending and infrastructure as election is closer. Unemployment will continue to stay low. Real personal income and consumption will increase because of the tax cut and the increase in real wages. However, business investment will decrease because the effect of reduction in corporate taxes and more pro-business government policies and regulations has dissipated. Both short-term and long-term interest rates will rise in anticipation that the Federal Reserve will continue to raise interest rate to keep inflation in check.

The consensus among economists is that real gross domestic product (GDP) will grow at about 2.7 percent in year 2019, decreasing from the growth rate of 2.9 percent in 2018. The major components of real GDP are consistent with this mixed growth trend.

Real personal consumption expenditures are expected to grow by 2.8 percent in 2019, representing a slight increase when compared with a 2.7 growth rate in 2018. In 2018, the growth rate in real personal disposable income was higher than the real personal consumption expenditures, resulting in more saving for consumers in 2018. In 2019, the higher consumer saving is expected to continue as the growth rate in real disposal income in 2019 (2.9 percent) is again higher than the growth rate of real personal consumption expenditure (2.8 percent). Housing starts are estimated to gain modestly from 1.27 million in 2018 to 1.30 million in 2019. Unemployment rate is forecasted to be at 3.6 percent in comparison with 3.9 percent in 2018.

However, private business activities will cool off in 2019. Real business fixed investment will grow at 4.8 percent (as compared to a growth of 6.9 percent in 2018). Industrial production is expected to decrease to a rate of 3.3 percent, compared with a growth rate of 3.9 percent in 2018. Since industrial production still grows faster than consumption, inventory buildup will increase in 2019 (75.3 billions), as compared to 2018 (41.3 billions). Car and light vehicles sales will decrease from 17.1 million units to 16.7 million units in 2019 as Americans slowed down their car purchases after record increases in 2017 and 2018. Oil prices will fluctuate around $66 in 2019, translating into higher transportation cost when compared with 2018 (USEIA, 2018). Interest rates are forecasted to climb up in 2019.

The following table shows Forecasts of U. S. Major Economic Indicators for 2018 and 2019.

Forecasts of U. S. Major Economic Indicators

Major Economic Indicators*	2018	2019
Real Gross Domestic Products	2.9	2.7
Industrial Production	3.9	3.3
Real Personal Disposal Income	2.8	2.9
Real Personal Consumption Expenditures	2.7	2.8
Real Business Fixed Investment	6.9	4.8
Changes in Private Inventories (in billions)	41.3	75.3
Net Exports of Goods and Services (in billions)	-916.3	-1,003.3
Real Government Consumption Expenditures	1.7	2.3
Car & Light Truck sales (millions of units)	17.1	16.7
Corporate Profits after tax	16.0	4.9
Housing Starts (millions of units)	1.27	1.30
Unemployment Rate	3.9	3.6
Consumer Price Index	2.4	2.3
Two-year US Treasury Bill	2.60	2.99
10-year Treasury Note	2.91	3.30
30-year Fixed Mortgage Rate	4.56	4.90
Oil Price (dollars per barrel)	55.0	66.0

*All numbers are fourth quarter over fourth quarter percent changes unless otherwise indicated.
**Source: Wells Fargo (2018).

In 2018, after-tax corporate profits grew by a record 16.0 percent as corporation benefited from a record year global economic recovery. In 2019, it is expected that corporate profits will continue to grow, but at a much slower rate of 4.9 percent, as the benefit of tax cut fades and real wages go up. It is expected that their after-tax profits will grow at -0.4 percent in 2020. As economy continue to grow, corporations will hire more workers. Unemployment rate will drop further, and real wage will pick up. A stronger job market means consumers will have more money to spend. Although the higher gasoline bills and the higher inflation will dent the consumers' pockets, but real consumption is expected to grow at a higher rate in 2019.

The 2019 national real estate market is predicted to grow at a stable pace when compared with the last year. Home prices are anticipated to increase 3.1 percent and existing home sales are forecasted to increase 1.0 percent to 5.4 million homes. Mortgage interest rates are expected to reach 4.9 percent due to higher inflationary pressure in the year ahead (NAR, 2018).

The S&P 500 finished 2018 with about -7.03 percent of return for the year. At the current index of about 2,485, the current P/E ratio of the market is about 19.60 times. For 2019, the forecasts vary in wide range. The more optimistic forecast estimated the operating earnings per share to be around $173. If the market P/E ratio remains constant, this suggests a 2019 year-end S&P Index valuation of 3,100.

Based on these numbers, the forecast for the return on S&P 500 is about 24 percent in the coming year, everything else being the same (Financial Samurai, 2018). The more cautious forecast, however, only expected the index to be at 2,750, yielding a return of 10 percent. Potential headwinds in 2019 include more rate hikes from the Federal Reserve, trade wars, geopolitical conflicts, and potential financial turmoil in emerging economies.

OUTLOOK FOR WORLD ECONOMY

Global economic growth is expected to be 3.7 percent in 2019, same as in 2018 (IMF, 2018). The growth will be around 2.1 percent for advanced economies and 4.7 percent for emerging markets and developing economies. The price of oil is expected to fluctuate around $66 a barrel. In the foreign exchange market, US dollars will become weaker because of US trade, fiscal, and monetary policies. The euro is forecast to close at $1.25 per Euro and Japanese Yen at 102 per dollar in 2019 (Skinner, 2018).

In the Americas, Canada's growth rate for next year is estimated to be 2.0 percent, down from 2.1 percent in 2018. Mexico's economy will grow at 2.5 percent, up from 2.2 percent for the 2018. Brazil's economy will recover from its growth rate of 1.4 percent in 2018 to a growth rate of 2.4 percent in 2019. The Argentine economy is expected to grow at the rate of -2.6 percent in 2018 and -1.6 in 2019. Chile's growth rate will decrease from 4.0 percent in 2018 to 3.4 percent in 2019. Venezuela is expected to reduce its recession rate to -5.0 percent in 2019 as compared to a -18.0 percent recession in 2018 that was caused by severe supply bottlenecks, challenges from capital flight, and weak policy frameworks.

In Western Europe, British economy will grow by 1.5 percent next year, up from the 1.4 percent in 2018. The Euro area is forecast to grow by 1.9 percent in 2019, down from 2.0 percent in 2018.

In Central and Eastern Europe, the growth rate is different depending on the specific situation in each country as compared to 2018. Russia's economy will recover from 1.7 percent in 2018 to 1.8 percent in 2019. Poland and Romania's growth will be 3.5 and 3.4 percent respectively in 2019, compared with 4.4 and 4.0 percent registered in 2018. Hungary's economy will slow down from 4.0 percent in 2018 to 3.3 percent in 2019. Turkey's growth rate will decrease to 0.4 percent in 2019 from 3.5 percent in 2018.

The economic growth in Asia is mixed for 2019, when compared with the growth rates in 2018. The four countries that will have the largest growth are India, Philippines, Vietnam, and China. In India, consumer spending continues to be the primary driver of Indian GDP growth. In China, residential investment should decelerate in coming year, because lending standards are being tightened again at the margin. Chinese economy will experience a "soft landing," growing at 6.6 percent and 6.2 percent in 2018 and 2019 respectively. The slowdown reflects China's over-leveraged business sector, especially its state-owned enterprises which are often kept afloat by the Chinese government.

The following is a table showing the projected growth rates in 2018 and 2019 for the countries in this region.

Table: Growth Forecasts for Asian Countries

Country	2018	2019
China	6.6%	6.2%
India	7.3%	7.4%
Indonesia	5.1%	5.1%
Japan	2.9%	2.9%
Malaysia	4.7%	4.6%
Philippines	6.5%	6.6%
Singapore	2.9%	2.5%
South Korea	2.8%	2.6%
Taiwan	2.7%	2.4%
Thailand	4.6%	3.9%
Vietnam	6.3%	6.3%

Source: IMF (2018).

RISKS AND UNCERTAINTIES

Several risks are inherent in the economic projections presented above. As we head into 2019, there are some major assumptions and uncertainties that we assumed in the forecast. These major assumptions and uncertainties are discussed below.

Across many economies, government and corporate debt is substantially higher than before the global financial crisis. The debt-to-GDP ratio in the Chinese economy has shot up over the past decade, with leverage in the non-financial corporate sector rising markedly. The recent increase in Italian sovereign yields is another case. A significant further decline in sovereign bond prices may cause valuation losses on investors, and concerns about sovereign-bank liquidity in the euro area.

Cybersecurity breaches and cyberattacks on critical financial infrastructure represent an additional source of risk because they could undermine cross-border payment systems and disrupt the flow of goods and services.

Geopolitical risks and domestic strife are also a risk in several economies, especially in the Middle East, Turkey, and sub-Saharan Africa. The depth of macroeconomic distress in several countries such as Libya, Venezuela, and Yemen may result in large GDP collapses in those countries and regions.

Furthermore, there is the risk of global trade tensions. With protectionist rhetoric increasingly turned into action with the United States imposing tariffs on a wide range of imports and retaliatory actions by trading partners, escalation of trade tensions to an intensity that carries systemic risk is a distinct possibility. An increase in trade tensions among major economies in the world could lead to financial market volatility and slower global economic growth.

Finally, many countries are vulnerable to the economic and humanitarian costs of extreme weather events and other natural disasters, which generally have potentially significant cross-border ramifications because of migration flows.

OUTLOOK FOR CALIFORNIA ECONOMY

California's economy will continue to expand as solid job and wage growth are anticipated against a backdrop of unaffordable housing and weakened worker mobility. Nonfarm payroll employment will grow at 1.7percent in 2019 as compared with 1.6 percent in 2018. Payrolls are expected to grow by 1.7 percent in 2018, by 1.8 percent in 2019, and by 0.8 percent in 2020. Unemployment will shrink to 4.2 percent at the end of 2019. Real personal disposal income will increase at 3.6 percent in 2019 versus 2.5 percent in 2018 (UCLA 2018).

California's housing market will post a nominal gain in 2019, as supply and demand balance out. Single family home resale will increase at 3.3 percent in 2019, reach 396,800 units, down from the projected 2018 sales figure of 410,460. The 2018 figure is 3.2 percent lower compared with the 424,100 pace of homes sold in 2017. Median home prices will increase by 3.1 percent from $575,800 in 2018 to $593,450 in 2019, compared with a 7.0 percent increase in 2018. "The surge in home prices over the past few years due to the housing supply shortage has finally taken a toll on the market," said C.A.R. Senior Vice President and Chief Economist Leslie Appleton-Young. "Despite an improvement in supply conditions, there is a high level of uncertainty about the direction of the market that is affecting homebuying decisions. This psychological effect is creating a mismatch in price expectations between buyers and sellers and will limit price growth in the upcoming year" (CAR 2018).

Regarding job growth, the sectors expected to add large number of jobs over the 2018-19 years are administrative and support services (137,400 new jobs) and health care and social assistance (100,300 jobs). After two years of falling job numbers, natural resources will stabilize and add 1,400 jobs. Manufacturing is also expected to grow in 2019 for a net gain of 30,040 jobs over the 2018 & 2019 years. This sector shed 166,700 jobs between 2007 and 2017, so while higher jobs counts over the 2018-19 two years are welcome, it is unlikely they will return to pre-recession employment levels (LAEDC 2018).

IMPLICATIONS FOR SMALL AND MINORITY BUSINESS

In summary, U.S. and world economy are expected to slow down in 2019 from previous years. Although the change in the US tax policies contributed to the higher growth in 2018, the effect of tax reduction will start to fade as times go by and US economy adjusts to the new tax rates. Although governmental spending might increase as the year of election gets closer, businesses should not expect any significant upside surprises from major changes in fiscal and monetary policies. Instead, they should be aware of the negative forces that can potentially harm the economic outcomes such as rising wages and interest rates, tightening immigration policy, and potential trade wars.

There are things that small business can do to improve their bottom lines in a period of economic uncertainty. First, small firms should continue to raise their productivity by incorporating information and communication technology into their operation. Second, as global uncertainty increases, the prices of the raw materials are expected to be more volatile in the future. Small and/or minority business should carefully plan their requirements of inputs and materials for the coming year to make sure the cost of them are under control. There are techniques to improve e-commerce, inventory planning, and to manage global supply chain. If any business needs assistance, please contact the Center for Minority & Small Business at the University of the West at (626) 571-8811, ext. 380.

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ABOUT THE AUTHOR:

Dr. Otto Chang is a reputed accounting and business educator with specialty in several areas, including taxation, management and international accounting, business ethics and philosophy, corporate governance and social responsibility. Born in Taiwan of Asian heritage, Dr. Chang attended National Taiwan University, receiving a bachelor's degree in economics. He came to University of Illinois in 1978 to complete his Master and Ph. D. degree in accountancy. He taught at the University of Wyoming, Texas Christian University, and California State University at San Bernardino (CSUSB). He was the Chair of the Department of Accounting and Finance, Associate Dean for Administrative Affairs at CSUSB, and Dean of the Doermer School of Business at Indiana University-Purdue University Fort Wayne. On June 4, 2018, he became the president of the University of the West.

Throughout his educational career, Dr. Chang received numerous awards and recognitions for his outstanding teaching, excellent research, and dedicated service to the community. His professional activities include more than forty-five publications; some of them appear in major academic journals, such as Journal of Accounting Research, Journal of American Taxation Association and Management Accounting. He is often called upon to conduct professional workshops to top-level management from all over the world and serves as consultant to several major firms in the United States and China.

The New FASB Accounting Standards for Nonprofit Organizations (Nonprofits)

By Fredrick Ho, CPA, MBA

Introduction

Nonprofits operate under accounting standards governed by the Financial Accounting Standards Board (FASB). There are several new standards effective for fiscal years starting after December 2017. This article focuses on the new guidance found in FASB Accounting Standards ASU 2016-14 (Topic 958), Presentation of Financial Statements of Not-For-Profit Entities.

The FASB's goals for the new rules are to provide better information to donors, grantmakers, creditors, and others who utilize nonprofit financial statements. The new rules will improve how a nonprofit organization can tell its story through its financial statements. FASB hopes the changes will improve the usefulness of nonprofit financial statements and/or reduce complexities and costs of financial reporting.

Which nonprofits need to pay attention to these new FASB standards?

Whether a nonprofit is required to have an independent audit or even certified financial statements prepared each year depends on many factors. Each state has its own regulations that set dollar thresholds for when a nonprofit must be audited. Some funding sources, such as a private foundation, or even a local, state, or the federal government, may require nonprofits to submit an audit. The changes described in this article apply to audited financials, but they can be useful to other nonprofits as well. Nonprofits use their financial statements to help tell their mission and program stories. Well-presented financials simply reflect a nonprofit's mission in another language. So nonprofit staffs need to learn the new standards well enough to be able to implement them in a way that tells their nonprofit's story effectively.

1. Restricted and Unrestricted Net Assets

How do the new accounting standards help a nonprofit tell its story about funding that is restricted for specific use?

The new FASB standards changed the terminology used to describe "restricted" contributions. Going forward there are two categories: assets "without donor restriction" and assets "with donor restriction." The ability for donors to place restrictions on the purposes - or on the time period - their donation can be used, is what makes nonprofit accounting unique – and complicated. For example, if an organization operates three programs and a foundation gives it a grant of $50,000 for program A, the organization has to set up accounting systems that are sophisticated enough to show that it spent $50,000 on program A. Likewise, if the donor gives the organization a gift specifically intended for a use that will be carried out at a future time, say in the next fiscal year, then the organization's accounting system needs to be able to show that the organization did not spend that money until the proper time period.

The process for moving funds from the "with donor restriction" category to the "without donor restriction" category is referred to as "releasing (funds) from restriction." Often, this will be addressed with a line item called "Revenue Released from Restriction" or "Net Assets Released from Restriction." This means money that came in with a donor restriction has now either been used for the purpose the donor intended or within the time period designated.

In the nonprofit world, sometimes gifts are received from donors that are intended to be held forever, like endowments or scholarship funds. The purpose of these gifts is to create a fund or pool of money that generates income through investment. The organization is free to use the earnings that come from the assets that are invested, but to honor the donor's intent, the nonprofit must hold the original gift forever. (Phrases such as "in perpetuity" or "perpetual in nature" are commonly used to describe this kind of restriction.)

No matter what kind of restriction a donor might impose, FASB standards require nonprofits to report finances in a way that makes it clear which funds have donor restrictions and which funds come without donor restrictions. Before these new FASB standards, there were three categories: "unrestricted," "temporarily restricted," and "permanently restricted." (See Exhibits 1 & 2) The new terminology condenses from three categories to two categories when displaying financial statements. (See Exhibits 3 & 4)

What will be presented on a nonprofit's financial statements in connection with restrictions?

The new terminology asks to list those revenues, funds, or net assets that do not have donor restrictions as "without donor restrictions," and those that are restricted as "with donor restrictions." A nonprofit can show these categories on its financial statements by having separate columns for "without donor restrictions" and "with donor restrictions." Or a nonprofit can make a distinction between the two by showing separate line items in the revenue section of the Statement of Activities (the statement that shows a nonprofit's revenue and expenses) or in the net asset section of the Statement of Financial Position (the statement that shows a nonprofit's assets, liabilities, and net assets – also called a "balance sheet").

Exhibit 1: Statement of Activities

Previous Presentation: Revenue

Previous Classification

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES				
Contributions	$ 4,233,098	$ 13,000	$	$4,250,098
In-kind contributions	74,837	-	-	74,837
Government grants	2,692,546	-	-	2,692,546
Special events, net of cost of direct benefit to donors of $608,853	2,106,429	-	-	2,106,429
Other revenues				
Investment income	294,177	41,416	-	335,593
Net realized and unrealized gains on investments	2,421	97,016	28,994	128,431
Miscellaneous income	11,731	-	-	11,731
Net assets released from restrictions	1,215,402	(1,215,402)	-	-

Exhibit 2: Statement of Financial Position

Previous Presentation: Net Assets

NET ASSETS	
~~Unrestricted~~	
~~Board designated operating reserve~~	~~3,158,984~~
~~Board designated strategic growth reserve~~	~~11,400,000~~
~~Property and equipment~~	9,286,537
~~Other~~	~~8,293,744~~
~~Total unrestricted~~	~~32,139,265~~
~~Temporarily restricted~~	~~2,926,049~~
Permanently restricted	~~1,409,634~~
Total net assets	36,474,948

Previous Classifications

Exhibit 3: Statement of Activities ASU 2016-14 Presentation: Revenues

	Without Donor Restrictions	With Donor Restrictions	Total
REVENUES			
Contributions	$ 4,233,098	$ 17,000	$4,250,098
In-kind contributions	74,837	-	74,837
Government grants	2,692,546	-	2,692,546
Special events, net of cost of direct benefit to donors of $608,853	2,106,429	-	2,106,429
Investment return, net	**294,667**	**165,426**	**460,093**
Miscellaneous income	11,731	-	11,731
Net assets released from restrictions	1,215,402	(1,215,402)	-
Total revenues	10,628,710	(1,032,976)	9,595,734

Two Classifications

Determination of Without Donor Restrictions remains unchanged from previous “Unrestricted” classification

Determined by adding previously classified Temporarily Restricted and Permanently Restricted together

Exhibit 4: Statement of Financial Position ASU 2016-14 Presentation: Net assets

NET ASSETS	
Without donor restrictions	
Board designated operating reserve	3,158,984
Board designated strategic growth reserve	11,400,000
Undesignated	17,580,281
Total without donor restrictions	32,139,265
With donor restrictions	4,335,683
Total net assets	36,474,948

Classification in ASU 2016-14

Even though it may be possible to combine all the funds “with donor restrictions” into the same column - or onto the same line item - on the financial statements, it will still have to disclose a detailed breakout of the different kinds of restrictions in the notes to the audited financial statements.

Nonprofits need to be aware that the move from three categories to two categories does not allow them to stop tracking those funds that a nonprofit receives from donors who ask to hold their gift in perpetuity. The nonprofit still has to keep track of its endowment or scholarship funds separately from those funds that are restricted in other ways.

What are practical ways nonprofits document donor restrictions?

The best way to document donor restrictions is to retain any correspondence the organization received when it was notified of the gift. The award letters or grant agreements or even the notes on a contribution envelope are all evidence of the donor's intent for how the organization is expected to use the money. The language the organization uses to solicit contributions can be construed to place a restriction on a donor's gift. If the fundraising appeal highlights one of the projects or programs very specifically, the organization may be inadvertently restricting any gift sent back to it in response to that appeal. It's all about being clear what the organization is asking for and being clear what the donor intends. Some nonprofits use "gift intent forms" to clarify restricted or unrestricted gifts that ask donors to describe, or check a box directing the nonprofit how to use their gift. One of the options can be: "Please use this gift wherever there is the greatest need" or some similar language that gives the nonprofit discretion over the use of funds. That form could also be used to verify whether the donor wishes to remain anonymous or not.

How are board-designated assets handled on financial statements under the new standards?

Boards are able to set aside certain funds the organization receives (or has built up over time) by designating that the funds only be used for specific purposes. Examples include establishing a board-designated reserve for emergencies. Or the board may be planning a program expansion or merger in the future, and may designate funds for that purpose. It is sometimes strategic for a board to make such a designation and display it on the financial statements. It shows a commitment to a certain plan or program or strategy. But there is a difference between these designated funds and funds the nonprofit receives that come with donor restrictions. Board-designated funds are actually funds without donor restrictions. Because it was the board that decided to set these funds aside for a specific use or to be used at a specific time, the board could just as easily change its mind and vote to free up the funds or change the purpose of the designated funds. This is different from restriction imposed by a donor. The nonprofit is legally obligated to honor the donor's intent, but since the board can change its mind about its own designated funds at any time, those assets are still portrayed in financial statements as "without restriction."

2. Liquidity Disclosures

How are nonprofits required to disclose information about their cash flow/liquidity in their financial statements?

The concept of liquidity is critical for nonprofits to understand. Often, it is a shock for an organization showing a positive bottom line to discover it doesn't have enough cash in the bank to make payroll. There is a difference between when the nonprofit has to report it "accrues" revenue and expenses, from when those revenues and expenses actually hit the nonprofit's bank account. For example, when a nonprofit receives the letter from a foundation awarding a $25,000 grant, it is proper accounting practice to book that amount as grant revenue on the date the letter is received even though the nonprofit may not receive the money for a week or longer. The grant is booked as a "receivable," meaning the nonprofit hasn't received the cash yet, but it still goes on the Statement of Activities as grant "revenue." But since the nonprofit hasn't received the actual check or wire for the amount yet, it doesn't have that cash in the bank available to pay its bills. If the nonprofit doesn't have any other reserves in the bank or extra money from some other source, then the nonprofit might still be in rough shape even though a financial report shows that the nonprofit just received a $25,000 grant!

This is why tracking and disclosing liquidity is so important. Liquidity refers to those financial resources available for use in the near future. The FASB standards ask nonprofits to both list the quantitative measures of their liquidity (financial resources available for use within the next year) and the qualitative measures (how the nonprofit manages and monitors its liquidity). So, to satisfy the new FASB standards, nonprofits need to disclose what resources they have on hand that could be used to cover expenses and other obligations within the next year. The nonprofit should also disclose how it defines what resources it can use and how it monitors the state of those resources. The list of available resources includes the obvious, like cash (that is, cash without donor restrictions) and certificates of deposit that will be paying out within the next year. Other available resources might include receivables like grants or client fee payments likely to be collected within the next twelve months. The grant of $25,000 used as an example earlier might be considered available resources if the actual check or wire is expected to be received within the year.

One less obvious available resource might be a line of credit the organization draws funds from in the form of a short-term loan if cash gets too low. Another source of available funds might be those grant funds with donor restrictions that are anticipated to be released from restriction within the year. While currently restricted by the donor, if the nonprofit knows it will be doing the project or program within the next twelve months, then it should include that amount of project funding as available for use within the same period. If the organization is reasonably certain that the donor restriction will be satisfied, then it can make a case that the money should be considered available.

Deciding on a liquidity measure that fits the nonprofit is an important step towards financial health. Even though FASB requires that the liquidity disclosure show what is available within the next twelve months, it might make more sense for the organization to pay attention to the next 90 days. It all depends on the normal cycle of its receivables. That is, the regular pattern of when the organization receives payments. For example, if the organization receives a large portion of its revenue from a government agency that takes 90 days on average to process reimbursement requests, then the organization might consider establishing liquidity measures based on a 90-day cycle. Sharing this in its financial statements will give the readers of the statements confidence in how stable the organization is and how well it can expect to meet immediate financial needs. Looking at liquidity is also a very important strategy for the organization's leadership. Leadership is always better off knowing the truth about the financial condition well ahead of any potential problems. It is easier to survive tough times if board and staff members are expecting them and can take proactive steps to change course.

3. Presentation of Expenses

How do the new standards impact the way a nonprofit will be describing its functional expenses on its financial statements or in the notes?

FASB's new standard on functional expenses is really just a change in how much detail nonprofits must provide about their expenses. For those organizations that are required to conduct an independent audit, the requirement to break out organizational expenses into functional categories –program services, management and general (also called administration), and fundraising – are not new.

The new standard requires nonprofits to break out their expenses not only by the three functional areas, but also by their "nature". "Nature" just means that it is necessary to list what specific line items the money was spent on within each of the larger functional areas. For example, nonprofits are now required to break out expenses into line items like salaries and other personnel expenses, occupancy expenses like rent or mortgage interest, or travel expenses. Many nonprofits already do this every year when they file the full IRS Form 990 (Return of Organization Exempt from Income Tax), so requiring this level of detail is not necessarily anything new.

Exhibit 5: Functional Expense Statement

	Program Activities				Supporting Activities			
	A	B	C	Programs Subtotal	Management and General	Fund-Raising	Supporting Subtotal	Total Expenses
Salaries and benefits	$ 3,819,131	$ -	$ -	$ 3,819,131	$ 406,786	$ 334,353	$ 741,139	$ 4,560,270
Supplies and travel	219,657	-	-	219,657	7,356	6,402	13,758	233,415
Services and professional fees	75,744	-	-	75,744	5,815	676,804	682,619	758,363
Office and occupancy	202,742	-	-	202,742	21,740	21,393	43,133	245,875
Insurance	60,206	-	-	60,206	6,690	7,433	14,123	74,329
Other	125,988	-	-	125,988	7,499	56,838	64,337	190,325
Recruitment of volunteers	217,508	-	-	217,508	-	-	-	217,508
Depreciation	263,738	-	-	263,738	29,304	32,560	61,864	325,602
Total expenses	$ 4,984,948	$ -	$ -	$ 4,984,948	$ 484,519	$ 527,367	$ 1,011,886	$ 5,996,834

However, the functional expense statement (See Exhibit 5) is one of the most often misunderstood and misused pieces of financial information that nonprofits are required to disclose. Many nonprofits are aware of the "overhead myth," the belief that nonprofits with lower operating costs are more effective. Too often donors, investors, and the public have used the information on the functional expense statement of a nonprofit's audit or Form 990 to judge whether a nonprofit is efficient or effective in its use of donated dollars to perform its charitable mission. The way this is often decided is to calculate what percentage administrative and fundraising expenses are of the total expenses of an organization. While seeking to know if a nonprofit is effective in carrying out its mission is a perfectly valid and worthy question, the functional expense ratio has not been shown to actually correlate to an organization's mission or financial success.

If nonprofits are being required to report a measure that neither accurately predicts nor reflects the mission or financial success of the organizations, it should at least find a way to make it useful. To that end, it is recommended going one step further with the functional expense statement than is required by FASB. The organization can add supplemental information in the form of extra financial statements or reports or note disclosures that come at the end of the audited financials. Instead of showing the nonprofit's program services lumped into one column next to a column for administrative expenses, and a column for fundraising, it could break out each of the specific programs into a separate column.

Next, the organization could choose a reasonable method for allocating the administrative expenses and the fundraising expenses to each of the program areas it just broke into columns. Some common allocation methods are FTEs (full time equivalents), percentage of direct expenses, or for the fundraising expenses it could use the percentage of contributed revenue in each program. Allocating administrative and fundraising expenses out to each of the program areas provides the "true program costs" of each of these programs. This shows how much it really costs to provide the services or programs of the organization. This is a much more appropriate, strategic, and useful way of looking at the functional expenses of a nonprofit.

4. Reporting of Investment Expenses and Investment Returns

Prior to the release of ASU 2016-14, there was no standardization of how investment returns were reported in financial statements. Effective for financial statements subject to the new ASU, investment returns will be required to be presented net of investment expenses on the face of the statement of activities. This will provide for a more comparable measure of returns across all nonprofit entities.

In order to report investment returns net of expenses, it is necessary for an organization to identify the related expenses. For many smaller nonprofit entities, these will consist of external expenses. Some examples include the fees paid to an outside investment manager, as well as those fees imbedded in the investment return vehicle, for example, mutual funds, hedge funds, etc. However, if the organization has any direct internal expenses, this process will be more cumbersome.

The FASB defines direct internal investment expenses as those expenses involved in the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. Examples of these expenses could include the salaries, benefits and other costs associated with the employee(s) responsible for the development and execution of the investment strategy, as well as allocable costs associated with internal investment management and supervising, selecting and monitoring of external investment management firms. It is important to note that direct internal investment expenses do not include items that are not associated with generating investment return.

Organizations have the option to present the amounts of net investment returns from portfolios that are managed differently or derived from different sources as separate line items in the statement of activities. For example, net investment return generated from operating cash can be shown separately from investment return generated from an endowment. Or, net investment return appropriated for spending can be shown separately from net investment return in excess of amounts appropriated for spending.

In addition to requiring investment returns to be presented net of expenses, ASU 2016-14 also changes the required disclosures. An organization is no longer required to disclose the netted investment expenses or the components of investment return. This could be a significant change for the users of the financial statements, if they were previously relying on the financial statements for this information.

Organizations should be proactive and start this analysis as soon as possible. If the organization identifies direct internal investment expenses, it will be necessary to figure out the best wat to capture and calculate the amount. Additionally, users of the financial statements will need to understand the changes to the presentation and footnote disclosures.

5. Underwater Endowments

In general, endowment funds can be established by either donors or a governing board and must be reported in the statement of financial position based on the existence or lack of donor-imposed restrictions. A donor-restricted endowment fund results from a gift with a stipulation that those resources be invested either for a long, specified period of time or in perpetuity. Endowment funds with donor restrictions are referred to as donor-restricted endowment funds and will be reported on the statement of financial position within the next assets with donor restrictions.

Those without donor restriction are referred to as board-designated endowment funds. A board-designated endowment fund is created when a governing board designates or earmarks a portion of its net assets without donor restrictions to be invested for a generally long, but not necessarily specified, period of time. Board-designated endowment funds will be reported on the statement of financial position within net assets without donor restrictions.

An underwater endowment fund is a donor-restricted fund whose current fair market value has fallen below the original gift(s) amount or the amount required to be maintained (by the donor or law). Prior to nonprofits adopting ASU 2016-14, accumulated losses are treated as a reduction of unrestricted net assets to present the endowment fund at the amount required (by the donor or law) to be maintained. ASU 2016-14 will require accumulated losses to be included within the related endowment fund as net assets with donor restrictions. This change will improve the disclosures and understandability of underwater endowment funds.

In addition to the new presentation of the underwater endowment funds, ASU 2016-14 will require the following enhanced disclosures:

- The governing board's interpretation of the ability to spend from underwater endowment funds,
- The organization's policy, and any actions taken during the period, concerning appropriation from underwater endowment funds, and
- The aggregate amounts, for all underwater endowment funds, of the following:
    - Fair value of the underwater endowment funds
    - Original endowment gift amount or level required by donors stipulations or law
    - Amount of the deficiencies for each of the underwater endowment funds (i.e., current fair market value less the original gifts(s))

6. Statement of Cash Flows

ASU 2016-14 continues to permit nonprofits to present operating cash flows using either the direct or indirect method. The ASU, however, no longer requires a reconciliation of net cash provided by (used in) operating activities to the change in net assets if a nonprofit elects to present cash flows using the direct method. By eliminating the reconciliation, which was considered to be an impediment, the FASB intends to encourage nonprofits to elect the direct method. A reconciliation from the direct method to the indirect method may still be reported if a nonprofit prefers to present one.

Continuing to allow nonprofits to elect the direct or indirect method retains the flexibility and freedom to choose the method that best serves the informational needs of a nonprofit's users – creditors, donors, grantors, and others – in a way that strikes a balance in improving relevance and understandability of information without imposing undue costs.

Direct method of cash flow

The direct method of cash flows presents cash flows from operating activities in line items such as cash received from contributions, cash received from service recipients, cash received from other income, cash paid for grants, cash paid for interest, cash paid to employees, and cash paid for other activities. In essence, the direct method line items present where cash comes from and where it goes.

In deciding to use the direct method, the organization may consider the following factors:

- Users can easily derive the same cash flows from operating activities using the indirect method when given a comparative statement of financial position and a comparative statement of activity; therefor, the indirect method adds no additional information to the financial statements.
- The investing activity and financing activity sections of the indirect method are prepared using the direct cash method; therefore, it may make intuitive sense to prepare the operating activity section on the same basis.
- FASB encourages reporting cash flows from operating activities directly by showing major classes of operating cash receipts and payments, as this may be more useful to a broad range of users.

Key Considerations

1. Many organizations do not look at their statement of cash flows closely. Converting from indirect to direct method is likely only beneficial for organizations with multiple large reconciling items such as realized and unrealized gains or losses, depreciation and contributions restricted for long-term purposes, among others.
2. The changes in the ASU do not materially change how nonprofits record underlying transactions. However, if an organization changes the presentation of the statement of cash flows, the impact and benefits to the users of the financial statements should be understood.
3. The majority of time spent to change from the indirect to direct method would be building a template to use in future years. This could be accomplished by identifying the noncash impact to statement of activity line items (A/R, A/P, accrued salaries, etc.).
4. ASU 2016-14 removes the main impediment to using the direct method by eliminating the requirement to also disclose the indirect method. Careful planning by management will remove the impediment of easily generating the direct method information.

Conclusion

The new FASB ASU 2016-14, (Topic 958) – presentation of financial statement for non-profits will be effective for financial statement for fiscal year beginning after December 15, 2017.

The purpose of ASU 2016-14 is to provide relevant information regarding:

-Availability of resources to meet cash needs for general expenditure within one year of the date of the statement of financial position

- Liquidity and financial flexibility

-Financial performance during the period

-Service efforts and ability to continue providing services

-Execution of its relationship responsibilities and other aspects of its management's performance

It's not so much whether the standard is positive or not. What is most important is for nonprofits to know that their financial statements are their own. Even within the bounds of FASB standards, nonprofits should learn how to use their financial statements and the note disclosures that are part of them to tell their own particular mission story to good end.

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Startup Financing 101

By Mark T. Hiraide, Esq.

Abstract

One of the most crucial aspects of any new venture is its financing. Recent changes in federal securities laws have made the prospect of raising seed capital to fund a new venture an opportunity available to all. This article provides an overview of the basic concepts of corporate finance necessary to capitalize a new business and discusses common terms in early-stage financing transactions.

The Jumpstart Our Business Startups (JOBS) Act of 2012 legalized equity crowdfunding and liberalized laws relating to raising early-stage capital. It made seed capital, previously available only to a select few, accessible by a new class of entrepreneurs. Restrictive securities laws in effect for the 90 years prior to the JOBS Act made it difficult to start and finance businesses for those who did not have relationships with capital sources or friends and family to provide funding. The JOBS Act made the prospect of creating a new venture an opportunity available to all.

Prior to raising capital, entrepreneurs must have a basic understanding of corporate finance and the early-stage financing process. This article provides this framework by explaining basic financing instruments and concepts and describes practical issues arising in the funding process.

How to determine amount of growth capital needed

A starting point in the initial financing process is determining the amount of financing needed to fuel the venture's growth over the first several years. Growth capital is provided by a combination of internally generated profits, borrowed money and equity capital.

An article in a 2001 issue of the *Harvard Business Review*[1] lays out a framework for managing growth that takes into account three critical factors: a company's operating cash cycle, the amount of cash needed to finance each dollar of sales, and the amount of cash generated by each dollar of sales. These three factors together determine what is called the "self-financeable growth" (SFG) rate, the rate at which a company can

[1] Churchill & Mullins, "How Fast Can Your Company Afford to Grow," Harvard Business Review, May 2001, p 135. [https://hbr.org/2001/05/how-fast-can-your-company-afford-to-grow]

sustain its growth through internally generated revenues. Based on a fairly typical set of assumptions for a distributor and a manufacturer, the formula estimates that the annual SFG rate for either a manufacturing firm or a distributor is approximately 16% annually (accounting for taxes, depreciation and asset replacements). Thus, under these assumptions, any growth in excess of 16% annually would require outside financing.

Letters of intent and term sheets

It may be advisable for the venture founders to negotiate the basic terms and conditions of the financing and incorporate them in a letter of intent or term sheet to propose to an investor or investment banker. But it is more likely that the term sheet will be prepared by the investor or the investment banker after such investor or investment banker has completed its due diligence.

Such letters of intent may be made nonbinding, by inserting a paragraph indicating that neither side is bound legally by the letter of intent, and that it is merely an expression of general interest on each side to set forth the basic terms and to continue to negotiate the detailed terms and conditions of the financing agreement. A term sheet summarizing basic and detailed terms may be attached to the letter of intent, or the terms can become a part of the letter of intent. Even though the letter of intent may be nonbinding, it will usually carry a strong moral obligation. Reputable venture capital funds and investment bankers customarily honor a "soft" letter of intent, and will not try to renegotiate such provisions.

A binding letter of intent, in contrast, does not contain the paragraph referred to above which negates any legally binding commitment by the parties. Such a firm letter of intent indicates that it is the initial step in the negotiation process which will result in a definitive agreement incorporating the basic terms set forth in the letter of intent as well as other minor and detailed terms and conditions. Such letters of intent have been held enforceable.

If the parties are firmly contractually bound by the letter of intent, but cannot agree on the detailed terms and conditions of the definitive investment agreement, a likely dispute will result if one of the parties insists on its legal rights under the binding letter of intent. There is also always the question of whether a court will enforce a binding letter of intent where all of the terms are not commemorated in sufficient detail so as to be enforceable.

If on the other hand the letter of intent and term sheet are detailed enough in articulating the terms and conditions of the financing, and the parties are committed to working out any details not included in the letter of intent, then a binding letter of intent may be appropriate.

While a letter of intent is in force, pending negotiations of the detailed terms and conditions of the definitive financing agreement, the venture should not negotiate with any other sources, whether or not there is a stand still provision (an agreement not to consummate or negotiate financing with any other persons) in the letter of intent. Most venture capital funds and investment bankers would likely terminate negotiations if the venture were to engage in an "auction" process, by shopping the financing with other financing sources after the letter of intent is signed.

After the investor group has performed its due diligence and has made substantial progress in negotiating the detailed terms of the financing, it may be willing to make interim loans to the venture pending the execution of the definitive financing agreement. Caution should be exercised in drafting such interim loans--in the event that a final agreement is not reached, such interim loans usually must be repaid within a short period of time, although the venture should be given adequate time to find alternative financing before it is to repay such interim loans.

Valuing the company

The single most important aspect in any equity financing is the equity dilution, that is, the amount of equity to be issued to the investors. As discussed below, such equity may be in the form of common stock, convertible securities, warrants or options to purchase common stock, or a combination of these securities. The amount of equity to be issued to the investor group represents a dilution of equity to the founders who have, up until such initial financing, owned 100% of the company. The negotiation of the equity to be given to the investors is usually based on a valuation of the company at the time of the financing, called the “pre-money valuation.” The amount of equity required by the investors is a function of their desired return at a time in the future when the venture investors determine to sell their investment and realize their capital appreciation.

Following is a simple example of this valuation process: If the venture investor invests $1,000,000 and obtains 50% of the equity, then the company has been "valued" at $2,000,000, consisting of an original or pre-money "value" of $1,000,000, plus the $1,000,000 invested in the company. A common and simple valuation method for establishing the pre-money valuation of pre-revenue startup ventures is the Venture Capital Method, first described by Prof. William Sahlman at Harvard Business School.

The formula is:

- Return on Investment (ROI) = Terminal (or Harvest) Value / Post-Money Valuation

Then: Post-Money Valuation = Terminal Value / Anticipated ROI

Where:

Terminal Value is the anticipated IPO or selling price for the company at some point down the road. The selling price can be estimated by establishing a reasonable expectation for revenues in the year of the sale and applying an estimated after-tax profit margin. The resultant after-tax profit is capitalized at a P/E Ratio comparable to other companies in the same industry or technology.

Anticipated ROI is the anticipated return of the investor based on his expectation of the Terminal Value and risk.

[Example: The venture needs $500,000 to get started. The investor requires an ROI of 20X.

The venture anticipates revenues of $20 million in the harvest year at an after-tax profit margin of 15%, or $3 million, valued at a 15X P/E ratio, or $45 million.

Hence, Terminal Value / Anticipated ROI = Post-Money Valuation

Or, $45 million / 20X = $2.25 million

Post-Money Valuation--Investment = Pre-Money Valuation

Or, $2.25 million--$500,000 = $1,750,000

Pre-Money Valuation = $1,750,000]

Note: If the investors anticipate the need for additional capital, reduce the Pre-Money Valuation by the estimated level of dilution. Thus, if the anticipated dilution is 50%, reduce the Pre-Money Valuation of $1,750,000 to $875,000; if the anticipated dilution is 30%, reduce the Pre-Money Valuation by 30% from $1,750,000 to $1,575,000.

Another method is the High-Tech Startup Valuation Estimator (or "Cayenne Valuation Estimator"), developed by Cayenne Consulting (http://www.caycon.com/valuation.php) to assist entrepreneurs and investors in estimating the pre-money valuation of startups. The Cayenne Calculator uses 25 questions and applies its algorithm to estimate the pre-money valuation.

In valuing the company, the venture investors and the founders must take into account future additional financing and the probable equity dilution resulting from such financing. Many sophisticated venture investors recognize the importance of having the founders keep enough equity to maintain a substantial interest and therefore incentive as proprietors of the venture. Most founders of new ventures want to retain a significant portion of the equity as incentives to the hard work and dedication required to make a new venture successful. However, many founders may be unrealistic in their attempts to retain voting control (i.e., a majority of the outstanding common stock). Such voting control may not be possible in light of the initial valuation of the company made by the venture investors and the equity dilution resulting from subsequent financings. However, voting control may not be necessary. Working control may be retained with less than 51% of the stock. Voting trusts or irrevocable proxies may be used to provide the founders with working control, even though they may have less than 51%.

After a company goes public, working control is usually effected by using the proxy machinery to nominate a slate of directors. Most shareholders of public companies will usually vote management's slate of director nominees, unless the company is performing poorly or management has been charged with some wrongdoing. Unless a large shareholder or block of shareholders threatens a proxy contest, the founders usually are able to control a company with substantially less than 50% ownership.

On the other hand, venture investors may not adequately consider the importance of equity ownership by the founders, as a continuing incentive for their entrepreneurial efforts. If the founders ever develop an attitude that they are merely the employees of the venture investors, then the entrepreneurial spirit and incentives as owner-managers may have been lost.

Sale of equity-- Common stock

Since most investors willing to accept the high risks of investment in a start-up or new company wish to obtain the rewards derived from equity ownership, a common method of initial financing is through the sale of an equity security: common stock, preferred stock or convertible preferred stock. Since the common stock usually carries the full right to participate in earnings and thus increases proportionately in value as the company grows in earnings and net worth, common stock is the usual method of investment for the founders and sometimes the initial outside investors.

Sale of equity-- Preferred stock

On the other hand, the initial outside investors may wish to own a security senior to the common. Preferred stock typically carries a liquidation preference. The liquidation preference is the amount which must be paid to the holders of preferred stock before any distributions may be made to the common stock. It is usually expressed as a percentage of the initial purchase price of the preferred. Thus, if the purchase price of the preferred is $10 per share, a liquidation preference of 1x will be $10 per share. During the post dot.com period (2000 to 2003), shrinking company valuations gave rise to so called “downrounds” -- purchase price and conversion prices at less than those of the initial financing, leading to multiple values of liquidation preference. Thus, in the depths of the post-dot.com era, some liquidation preferences reached 2x, 3x or even higher to compensate the venture capital fund investors for their additional investments at lower valuations than those of the initial financings. Since 2003, however, many if not most funds have gravitated back to the 1x liquidation preference.

Non-participating preferred stock obtain the liquidation preference but do not share in any additional distributions with the common stock. A participating preferred does participate with the common, after the liquidation preference has been allocated to the convertible preferred, usually on an as-converted share-for-share basis.

The liquidation preference is payable on either a liquidation of the company, sale of assets, merger, consolidation or any other reorganization which results in a change of control.

Often preferred stock is sold to the outside investors with the right to convert such preferred stock into common stock. The conversion feature will allow a preferred holder to elect the alternative yielding the greatest return -- either converting into common stock or, alternatively, receiving the liquidation preference. Thus, the investor retains the choice of either accepting the liquidation preference, or participating *para passu* with all of the other shareholders of the company in the reorganization by converting its convertible preferred stock into common stock.

Preferred stock also may give the holder the right to payment-in-kind (PIK) dividends. A PIK dividend accumulates, usually whether or not earned, and is added on to the liquidation preference of the preferred stock and is payable by issuance of additional common stock in an amount equal to the PIK dividend.

Sale of equity—Basic tax considerations

In most instances a contribution of property to a corporation for stock may be structured to avoid taxation at the shareholder level. However, the contribution of services, may have potential adverse tax consequences, as Section 83 of the Internal Revenue Code ("I.R.C."), which treats a transfer of stock in connection with the performance of services as taxable compensation. Thus, the unrestricted receipt of stock by a founder in whole or in part for the performance of past or future services is taxable to the recipient.

If a shareholder recognizes income on the receipt of stock for services, the amount taxable is the difference between the fair market value of the stock and the fair value of any consideration given for the stock. The amount is taxable at the time the recipient acquires a beneficial interest in the property, disregarding any restriction which by its terms will never lapse. An example of a nonlapse restriction is a requirement that the employee/shareholder sell the stock back to the company at book value on termination of employment. Another example is a permanent right of first refusal to the corporation on sale of the employee's stock. Lapse restrictions that delay recognition of the income are restrictions that raise a substantial risk of forfeiture or that make the stock nontransferable. If the stock is issued subject to a lapse restriction, the time of recognition of taxable gain occurs when the property is transferable or is no longer subject to a substantial risk of forfeiture. The fair market value is determined at the time of the lapse of restrictions and the amount of gain is based on that value.

Under a special election provision, I.R.C. § 83(b), the recipient of stock subject to a lapse restriction may elect to close the transaction, disregarding the restriction, and recognize the gain at the time of the receipt. The benefit under current tax law to such an election would be to prevent recognition of the gain at some later time on a lapse of the restriction, when the amount of taxable gain might be considerably more, and to preserve capital gain treatment for subsequent increases in value. In general, this election must be filed with the I.R.S. within 30 days of receipt of the stock.

Another tax consideration with respect to the use of preferred stock is the provisions of Section 305 of the Code, which provides that a distribution by a corporation with respect to its preferred stock is taxable, generally as a dividend if the corporation has earnings and profits. If the preferred stock has a convertibility feature, and the conversion ratio is adjusted other than to take account of a stock dividend or stock split, a holder will likely have a constructive taxable distribution at the time that any preferred dividends are accrued and unpaid. An increase in the liquidation amount of the preferred stock, with an adjustment to the additional common stock into which the preferred stock can be converted, could cause such a constructive distribution.

Sale of debt

The founders may prefer to loan sums to the new company in exchange for debt securities, so that repayments of such capital may be made when the company's operations and financial condition permit. Such amounts would not be taxable as dividends if they are properly structured as debt repayments, whereas any amounts invested by the founders in exchange for common stock would be locked in as equity capital and could not be taken out without being taxed as ordinary income dividends if the company had earnings and profits.

Outside investors may prefer to advance funds in exchange for debt securities which are senior to the equity securities issued to the founders. In a high risk start-up venture, this distinction may not be meaningful, since if the company fails or becomes insolvent, there will not likely be sufficient assets to repay the debt. Hence, the difference in equity securities and debt securities may not be meaningful if the business fails. However, venture capital investors may wish to create a security interest in the assets of the venture, e.g., the intellectual property representing the technology being financed. Thus, in an insolvency situation, the venture investors may be able to recover by foreclosure the intellectual property in priority over the unsecured creditors of the venture.

Since many venture capital funds require some income from their venture investments to defray their own operating expenses, the use of convertible debentures allows the venture to pay such amounts as interest on a tax deductible basis. However, until the enterprise has taxable income, whether the payments are deemed to be interest on convertible debt or dividends on convertible preferred stock will not affect the company's current tax liability.

Debt/equity combination-- Convertible debentures

Since most risk investors wish to have an equity interest, convertible notes or debentures offer investors a senior security, as debt must be repaid before equity. Thus, convertible debentures have preferences on liquidation, payment of interest and other rights senior to common and preferred stock, while offering the investor the right to convert such debentures into common stock at his or her election at a time when the conversion equity security is more valuable than the principal amount of the convertible debentures. Typically, convertible notes mandatorily convert into a qualifying venture capital round, with a 10% to 25% discount to the price at the qualifying round. A qualifying venture capital round is usually defined by the size of the investment. Sometimes the convertible notes include a provision allowing the notes to be converted into common or series A preferred at a multiple and a floor and/or a cap for the valuation amount. The argument here is that such a structure would tend to protect the angel investors from being crammed down as they would be if they held a simple series A preferred invested at a higher valuation.

Debt/equity combination-- Debentures with warrants

Debentures with detachable warrants offer the same election to the holder, except that the warrants may have a longer term than the debentures so that investor could obtain repayment of the debentures but continue to hold warrants to purchase common stock after the maturity of the debentures. If the warrants are coterminous with the debentures, there is no real difference in such a security as compared with convertible debentures unless the debentures with warrants are prepaid before the warrants expire.

Simple Agreement For Future Equity – SAFEs

A commonly used seed investment security is a Simple Agreement for Future Equity or "SAFE."   The SAFE is similar to a convertible note, as it converts the investment at a discount into the securities sold in a qualified financing and sometime includes a valuation cap.   It is unlike convertible debt, however, as it is not debt and there is no maturity date and no obligation of the company to repay the investment.

Anti-dilution formulas

Convertible notes and convertible preferred stock usually will have some form of anti-dilution provisions which protect the holders from subsequent issues of common stock at prices less than the conversion price of the convertible security. Such anti-dilution provisions have different formulas and should be carefully reviewed by the company's management and counsel.

Affirmative and negative covenants

Investment and loan agreements usually come with an extensive set of affirmative and negative covenants which restrict the company's ability to effect certain transactions, such as incurring indebtedness, mergers, increasing compensation, and issuance of additional equity securities. These should be carefully reviewed with counsel at the outset.

Retention of control-- Sale of equity securities

Dilution of ownership by virtue of sale of additional equity securities is an important initial consideration. If substantial amounts of equity are to be sold to outside investors, certain mechanisms such as irrevocable proxies, voting trusts and use of convertible preferred stock may be employed to facilitate retention of control by the present owners and management. Changes in common stock voting provisions may be possible, including different voting rights, nonvoting stock, or common stock with "springing voting rights" triggered by specified events such as failure to pay dividends.

Retention of control-- Buy-sell agreement

Control may also be effected by buy-sell agreements or right of first refusal agreements which require the sale of stock back to the company or the present shareholder group. Preemptive right provisions may be incorporated into the agreement or the articles or bylaws allowing the existing shareholders to participate in any future issuance of stock to the extent of maintaining their respective ownership of stock.

CONCLUSION

Early-stage financing is the lifeblood of a startup company. It will affect the company and its founders throughout the lifetime of the company and will be a significant factor in the success or failure of the venture. How much a startup raises, the type of securities issued and on what terms are critical questions that entrepreneurs must answer before embarking on the path to raising early-stage capital.

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Hype vs. Reality – AI Adoption for Small Businesses

By Chi Sheh, PhD

Abstract

Artificial Intelligence (AI) has been called by many experts the most transformative technology of our era. While most of the attention in the media and research on AI centers on the development and application of AI in large enterprises, AI has increasingly become part of how small businesses stay competitive too. This article provides a framework for how small businesses should prioritize the adoption of AI in the years ahead. This article will also explore how small businesses can use artificial intelligence now, as well as the pitfalls that small business leaders should avoid, given the financial implications and technical risks.

Introduction

Artificial Intelligence (AI[1]) is being likened to a Fourth Industrial Revolution, due to its potential for creating a profound level of change in people's lives, much like the invention of steam engines (First Industrial Revolution), electricity and mass production (Second Industrial Revolution), and the rise of the digital age (Third Industrial Revolution) had in the past.

Artificial Intelligence and Machine Learning[2] (ML) applications are everywhere, from ride sharing companies to voice search on mobile phones. As many of us use AI every day, in the palm of our hands on our smartphones or on our computers and other digital devices, it feels so accessible to consumers that it must be within reach for small business leaders, too.

"For most companies today, the real value of AI comes from its ability to do the grunt work for you", says Marco Casalaina, the Vice President of Product Management, Einstein, Salesforce. In sales, it does the grunt work of finding opportunities and forecasting. In service, it interacts with customers and handles long-running processes. In marketing, it handles target marketing. In e-commerce, it handles product recommendation. In operations, AI helps companies with everything from preventative

[1] AI is the theory and development of computers to perform tasks that normally require human intelligence, such as visual perception, speech recognition, pattern recognition, and decision-making. AI makes it possible for machines to process huge amounts of data in order to identify patterns, glean insights from the data, and take actions based on those insights. AI goes beyond the predictive analytics of traditional business intelligence and uses prescriptive analytics to show what businesses should actually do.

[2] Machine learning is a subset of AI which uses algorithms that enable computers to "learn" and improve as they process large quantities of data (hence its association with "Big Data").

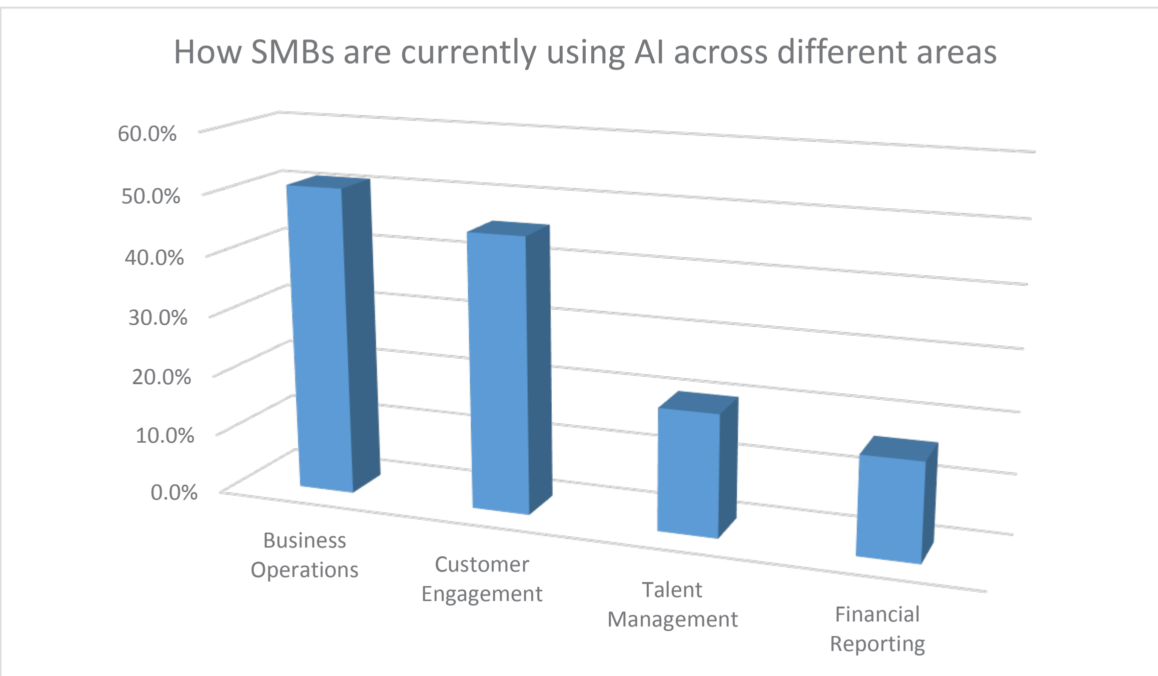
maintenance to solving problems on the production line, to optimizing settings on machines. So AI truly cuts across all areas of business today.

According to a recent survey by Vistage of 1,467 small and midsize businesses (SMBs), 13.6% of respondents said that they are currently leveraging AI in their businesses, with 6.9% using it for business operations and 6.1% for customer engagement. Nearly one-third (29.5%) of respondents indicating that AI is among the technologies that will have the greatest impact on their business in the next year. Small companies are finding ways in which AI can help predict customer behavior, personalize customer experiences, automate rote tasks, improve marketing strategies, managing supply chains, and many other areas of business.

Here are some statistics from the Vistage survey of SMB CEOs:

- 73.2% of CEOs plan to invest in business software or apps in the next 12 months
- 45.5% of CEOs plan to invest in customer relations management apps in the next year
- 57.6% of CEOs believe that advanced technologies will impact their business in the next year

Real-world applications of Artificial Intelligence



Source: Q2 2018 Vistage CEO Confidence Index

Joe Galvin, the Chief Research Officer at Vistage Worldwide said: "Artificial Intelligence is already all around us. While the future of AI is vast and unlimited, the practical applications are just beginning to emerge. Early adopters are beginning to realize the benefits of automation and the deep insights harvested from big data.

Given the inevitability of AI's applications across sectors, many of us immediately assume that it would seem a good idea for small businesses to jump on the AI bandwagon sooner rather than later to become more competitive. But at closer inspection, this assumption is wrong, and this article will examine why.

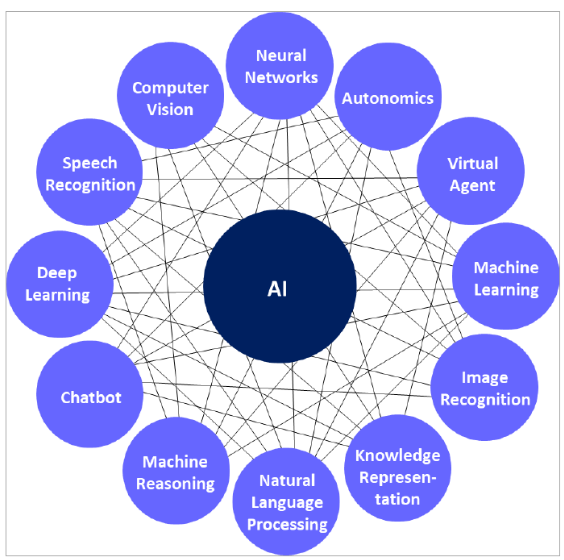
In this article I will aim to lay out a framework for how small businesses should prioritize the adoption of AI in the years ahead. This article will also explore how small businesses can use artificial intelligence now, along with pitfalls that they should avoid, so that small business leaders will see why it is very important that small business leaders act with prudence. Small businesses have limited budgets and typically lack technology expertise. They also have other competing needs for their limited capital. So we will examine the role of ROI in determining the best areas to deploy AI, which should lead to the best bang for their buck of their total IT budget.

How Small Business Leaders Should Think About AI

Despite the seeming proliferation of artificial intelligence technology today, it is still in the very early stages of development. Contrary to what might be hyped on social media, in nearly all application areas AI is an expensive and complex solution without evidence of direct ROI. This is especially relevant for small businesses with limited data, limited resources, and limited data science talent.

Modern machine learning is good at detecting patterns in data. It is good at optimizing processes in some cases. By no means does AI solve nor do whatever people want simply because they need it to. "Making" AI do something new in its present stage of development implies a lot of hard work and real research effort, requiring resources that the vast majority of small businesses do not have.

The Building Blocks of Artificial Intelligence



Source: HfS Research, 2018

There are many reasons why AI might be off limits to small businesses; here are the two main reasons:

1) **Need for highly skilled (and expensive) talent**

   AI technology is currently a "dark art" in the sense that it requires highly specialized talent. There are a very limited number of people with the requisite high-level skills to actually get their hands dirty and build an AI application to drive business value. It is hard science and takes a lot of time – more time than most enterprises can bear, never mind small businesses.

   Additionally, building AI applications is not a solo endeavor, it commonly involves team of experts within the business – many of whom must be trained in the novel science of AI. Putting such a team together is challenging even for the largest enterprises in the world. Since the talent is rare, they are much in demand with companies doing big things with AI/ML such as Facebook, Google, and Amazon. Consequently, AI talent can demands massive compensation, for which most small businesses simply do not have the budget.

2) **Data and Infrastructure complexity**

   On top of the talent needs, AI technology also requires data governance and infrastructure that is vastly more complex than that which most small businesses can afford. These are just two of the basic requirements to leverage AI technology effectively, and for small businesses they are daunting.

Leveraging Technologies and Applications that Use AI

That said, small businesses could still leverage technologies and applications that use artificial intelligence. This is by way of companies who can offer AI-integrated easy-to-use technology products. Most small businesses could experience artificial intelligence now by using AI products "off-the-shelf," so to speak.

Think of it as computer software such as a document editor or customer relationship management. These are readily available and user-friendly. Small businesses have no need to build their own software. They use applications (like Salesforce, Microsoft Word, Excel, Access) built by other people who know how the applications work and how to make them efficient.

Here are some areas where small businesses can leverage AI related technologies:

1) **Advertising**

Small businesses are leveraging AI today are in programmatic advertising companies such as Facebook and Google. These technologies are simple to use, as they are built by consumer tech firms who are expert in creating easy-to-use technologies.

Both Facebook and Google's advertising platforms use artificial intelligence and machine learning in very robust ways. If Facebook is provided with an email list of 2,000 people for an ad campaign, it will use artificial intelligence to find those users on Facebook, find the commonalities between them in terms of what they like, where they live, what is their gender, what do they do, etc. In order to create "look-alike campaigns," Facebook will use an algorithm to target similar people on Facebook to match and cluster these users. Facebook then uses an algorithm to look at everybody bidding to get exposure to different types of individual users and determine what ads get shown and when. Advertising is spread out across all of those users in real time, and to ads that Facebook believes not only will encourage them to engage and click, but also find useful or enjoyable.

Facebook uses AI and machine learning to provide a better user experience to the benefit of the user as well as for businesses. They want to put ads in front of people who are likely to do something with them, and this encourages spending from their advertisers. Google does similar things with its own advertising. Small businesses who can effectively use these platforms can benefit from these services in a very real way.

2) Data Security

Aside from programmatic advertising, small businesses can also leverage AI applications on data security using vendor companies. For example, in businesses that involves high IT or complicated IT security infrastructure, serious fraud detecting and security applications will be needed to keep its systems safe from malicious activity. This is actually a necessity rather than an option for this type of small business. Small companies are more vulnerable to hackers than large companies are because so many of them do *not* have adequate checks in place.

Data security is a serious issue for any business that accepts online payments through credit cards and debit cards. In most cases, merchant account companies have their own security measures in place, and a good number of these have embraced AI technology. Stripe, for example, is a payment processing company that uses adaptive machine learning to detect fraud. It collects data from all thousands of businesses already running Stripe to improve its ability to detect anomalies and malicious activities for new users. Stripe, too, works out of the box and is easily customizable for any business owner.

Hype vs. Reality – Focus on ROI and Business Strategy

Small business owners can leverage AI by using what is currently available from vendor companies' right out of the box. Many are already using these types of application without knowing anything about AI simply by placing an ad on Facebook or Google, or accepting a payment through Stripe. These applications are a simple and cost-effective way to drive value of AI for the company. However, small business leaders should remember that AI in small business is a means to an end, not an end in itself. It is very easy to be seduced by the hype of AI technology vendors. One pitfall to avoid is to feel the need to use applications just because they use AI. At the end of the day, AI is not magic. AI, no matter how technologically advanced, will not solve business problems or ensure the success of the business by its mere presence.

This applies even when placing ads on Facebook. Placing ads on Facebook may not be a good use of the limited marketing resources of the small business, no matter how small an investment. It may be that the business can be marketed more effectively offline, such as through a local network or trade show. However, some small business leaders might be thinking that since Facebook uses AI, it must be a good place to spend its limited marketing dollars. That is not the case at all. If Facebook is not the best advertising venue, then it is not a good place in which to put the businesses' ad money, AI or no AI. Smart business leaders should use Facebook or any other social media advertising only if it makes sense, and not use it if it doesn't make sense.

Instead of asking where AI can be used in the business, small business leaders should think about the areas where AI technology has the potential for generating the highest return on investment. Software should be chosen that can help the business achieve concrete business goals. No AI software or company should be picked based simply on the latest uses of AI, with the mistaken idea that doing so will make the business cutting edge.

The smart and responsible small business leader will pick the software that has the best use cases to achieve their business goals and to give a positive return to the company. If that happens to use AI, then so be it. The business can leverage AI through existing vendors that are using AI for email, security, payment processing or advertising, but no small business should be picking software because it AI is there somewhere.

For one thing, many companies that say they are doing AI are not and those that are really doing AI have products that are too complicated to use in small businesses. For another thing, AI is a buzzword that may not benefit a small business. When choosing software or services, it is important to think about which software has the features, the prices, and the support that are going help reach the business reach its business goals, and as a consequence drive growth and profitability for the small business. The business should not simply look for ways to incorporate AI, it should look for ways to use AI to execute its business strategy.

AI as an Engine for Growth for Small Businesses

Since AI is eventually going to be the backbone of business just as computers and software are now, companies inevitably want to set themselves up for adoption in the future, and that's a topic worth considering for small business leaders with significant goals for growth.

There are two very possible circumstances where small companies might get more involved with AI rather than simply leveraging somebody else's AI tools that are "off-the-shelf" tools:

Scenario 1

In the near future, more and more AI applications will not involve a significant stream of data from small business clients. These applications will likely leverage data from many, many client companies (small and large), and train an AI-based system so that any new client will not need huge reams of data.

For example:

- A marketing automation vendor might determine the best times of day to send certain kinds of promotional emails – or might determine the best way to split-test email subject lines – by working with thousands of e-commerce companies. When a new, smaller ecommerce company begins using the same product, they're able to begin leveraging this past training data without having to generate it themselves.
- A security and surveillance vendor might train it's algorithms to detect suspicious behavior by consuming millions of hours of security camera footage from thousands of clients. When a new client uses this security service, they're able to leverage all of that training data to detect security threats without providing the data themselves.

Scenario 2

A second circumstance where a small business may have an active role in leveraging data is if it grows to such a degree that they can actually afford to build some of their own AI applications. These businesses may be able to hire the expensive hardcore data science and AI people that are needed to build a unique AI application, such as a custom app, a specialized bit of software, or an automated employee feedback system.

Alternatively, AI may become as accessible as many software are today, which allows a small business to build its own applications without the need to commit massive resources. AI technology is not yet on par with computer software in terms of accessibility, but it may happen someday.

Realistically, though – as of today – most small businesses cannot actually leverage AI in a significant way today. In most cases, small businesses cannot "do" AI in a way that will provide legitimate near-term ROI. AI-specific startup with technical cofounders aside, most smaller companies should simply focus on revenue, growth, and data infrastructure – not on "finding a way to use AI" just to fit in.

Small business leaders can do something right now to help them prepare for the time when they qualify for either of the two scenarios described above, and that is:

- **Treat data as your MOST valuable resource**

The need for data is the one thing these two scenarios have in common, and solid data infrastructures will be positively necessary for the AI developments of the future. That is why it will be important to establish a system that effectively collects the data that fuels the AI systems of the present as well as the future.

AI tools require copious amounts of data to "learn," so the best way for leaders to prepare for the future with AI is to make sure their data is easily retrievable using compatible formats. It is important that important business data does not exist simply in a silo and distantly separated. Having a streamlined data infrastructure as part of the DNA of a small business is something that will ultimately be of benefit to its future performance.

Conclusion

Asking the right questions can make a big difference. Why do you want to do this? How are you going to implement it? Who will manage the implementation process? What is the timeline for the implementation? What is the projected ROI? What do you think AI will do for your business? These and many other relevant questions should be asked by the leaders of small businesses to themselves. A dose of realism in what AI can and cannot do will be crucial in order to avoid the pitfalls that can plague the adoption of any new technology, especially one as powerful as AI. Small business leaders need to have a clear answer to these questions, especially because there really is not that much that small businesses can do right now with AI.

In summary, here are the main conclusions:

- AI is not magic – it will not solve business problems instantaneously
- AI is still a dark art – it often requires a commitment of massive resources and hardcore data science and data analytic skills to build applications
- AI for AI's sake is a bad idea – choose the tools for the value it can deliver to the business, and not because it uses AI in some form
- Some small businesses can already use some AI applications out of the box – best examples are in marketing, logistics, operations, and fraud detection
- Data is the key to AI – AI needs data to "learn" and work properly
- Data is a valuable resource – small business owners need to store and record data in a consistent manner for eventual use with AI

Most small businesses today are not ready to take on AI initiatives. However, that does not mean that they should not keep an eye on AI tools that might affect their industry. By being aware of what bigger companies in their industry or similar industries are doing with AI, smart small business leaders may be able to take advantage of select niche AI opportunities.

There will come a time in the near future when AI will become as accessible as business computer software is today, which is when properly stored data will become invaluable. However, that time has not yet arrived. In the meantime, the best thing small business leaders can do is to grow their business and take steps to make it profitable. If small business leaders can work diligently to acquire the financial and specialized human capital needed for AI adoption – it will be in a position to leverage AI as it becomes "small business accessible" in the near future.

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BRIDGING THE MANAGEMENT GAP:

Tactical Strategies for Accessing Critical Expert Help for Your Small Business on Affordable and Flexible Terms

By: Professor Meskerem Tadesse

ABSTRACT

The average small business owner possesses the core expertise and strong passion for his/her business idea. Unfortunately, the lack of technical and management expertise often handicaps the entrepreneur's ability to focus on the core business as one ends up juggling various competing tasks, often without the prerequisite experience or access to the necessary expert help. This is generally true for small business start-ups where the owner-operator attempts to build a new business without the key expertise or resources, claiming the "I cannot afford it" excuse. This article underscores the pivotal role of professional and executive management expertise necessary to optimize an entrepreneur's business dream. Mindful of the underlying constraints, the strategic alternatives offered herein for accessing key technical and executive resources can be structured on affordable and flexible terms.

The success of a new business is dependent upon the ability of the entrepreneur to focus on his/her core expertise, equipped with a basic infrastructure and a synergistic team of functional, technical and executive management experts and advisors to take the new business through its optimal progression. The objective of this paper is to offer alternative venues that can help the typical owner-operated small business to bridge the management and expertise gap in a systematic and strategic manner until the business can afford its internal executive team on a more permanent basis.

Unpacking Our Topic

While the article strongly advocates the need for senior expert help in key areas, it does not overlook the practical constraints, i.e. the lack of capital (human, technical, financial and management expertise) that forces small business owners to attempt the impossible task of building and managing a new business singlehandedly. A close look at our topic will demonstrate how a short-term strategy can be devised to provide the necessary expert help that can unleash the small business owner's ability to operate confidently and competently so as to optimize the core business objective and mission.

Let's Analyze Our Topic

- **BRIDGING** - interim until you can afford your own internal team of experts
- **MANAGEMENT GAP** - Area of expertise needed, but lacking, to fulfill the business mission
- **CRITICAL** - Prioritizing key need areas, depending on your specific situation
- **SENIOR** – Experience / wisdom / respect /networks / practical insights and high-level expertise
- **AFFORDABLE** - Customized to be financially feasible for your unique situation.
- **FLEXIBLE** - Can be devised in various forms and as needed—hourly, project- and time-specific, etc.

Bottom Line: You do not have to hire them full time. The key is to focus on each of the above in light of your respective needs and unique business situation so that you can identify and engage the right type of expertise on as needed and case-by-case basis.

You Cannot Afford Not To Afford Critical Expertise If You Want To Succeed—High Priority

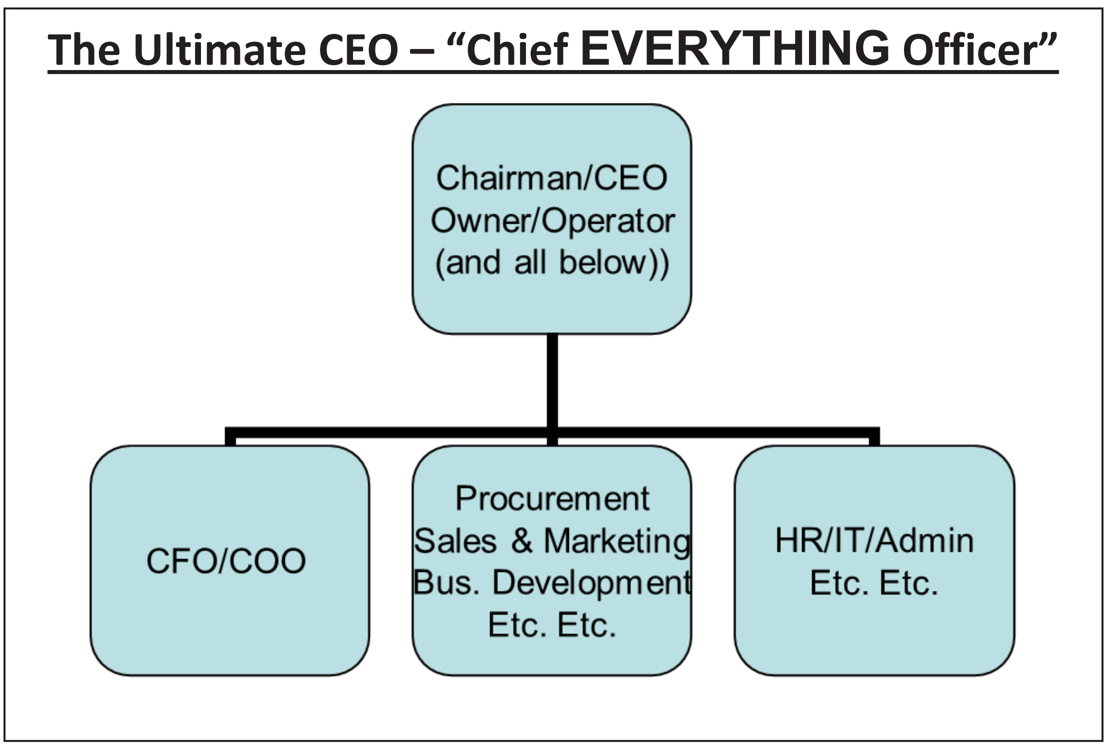
Success is an aspirational objective, and one should remove any and all known obstacles out of the way. Accordingly, an entrepreneur must get rid of the "I cannot afford it" mental hurdle that often stands in the way of your optimal business success. Business is like a team sport, and any serious team requires a synergistic team of athletes and coaches in order to compete, let alone to win. Following the sport analogy, it is no surprise that winning teams pay very high salaries to attract key players, because they know they hold the key to winning and that the winning prize they bring will pay for itself and more. Winning teams also know that championships cannot be won by a single expert player--it takes a well-rounded team to win! Likewise, business success is dependent upon having a synergistic team of experts who can achieve the targeted objectives more efficiently and effectively. Such expert resources can come as individual expert(s) such as consultants or assembled as a synergistic resource team such as advisory board.

Bottom Line: The consequential damage of not planning for and securing good technical and management expertise can be the difference between success and failure. Access to critical expert resource, no matter how costly, will more than pay for itself and may actually be your business lifeline, without which your business may not exist.

No One Can Do Everything Alone---Especially Running A Business!

"Those who try to do everything by themselves are referred to as Jack of all trades and master of none"—not exactly the label a budding entrepreneur seeks for oneself. Unfortunately, the typical owner-operated small business entrepreneurship often exists under an all-in-one organizational structure where the owner-operator implicitly or explicitly holds all or most of the key operational and management roles, begging the question: "What Were They Thinking"?

<u>The Typical Owner-Operated Small Business' Organizational Structure</u>



Is This A Winning Strategy-A misguided "Lack Mentality?

=➔<u>YOU NEED TIME TO FOCUS ON YOUR CORE EXPERTISE</u>!

➔ <u>Remember Why You Went into Business---Your Passion!</u>

Bottom Line: There is a good reason why the airlines say "BRING ONLY YOUR CARRY-ON BAG", leaving the rest to those equipped to handle it. No one can do everything, at least not well enough to succeed. Your core expertise is your carry-on bag. Entrepreneurs should focus on their core expertise; delegate staff work to others; and seek expert help for technical and top management tasks--It is more cost effective, efficient, productive and profitable.

The High Cost of Going It Alone

The average owner-operator of a small business who attempts to build, operate, grow and sustain an entrepreneurship alone will inevitably find out that one may start a business alone, but it is almost impossible to do it all alone. In fact, regardless of the size of a business, the same basic organizational structure and processes are required to be successful. Trying to do it otherwise is sure to result in an undesirable and potentially destructive situation, both for the business as well as the entrepreneur in many ways, including:

- The over-worked/over-stressed "busy-body" entrepreneur, risking the business and one's own health!
- Financial and emotional stress with no one to turn to
- Lack of focused strategy and business organization
- Missed business opportunities and costly mistakes
- Risk of business failure and tax/regulatory problems that may outlast the business
- Inefficient use of limited resources, especially the entrepreneur's ability to focus on his/her core expertise--sacrificing their dream that may otherwise be a great success.
- Looking for help after it is too late; and
- Losing it all, especially the fire and passion of the entrepreneur--indeed the highest cost

> *"There is a difference between being in a business, and being in the business of being busy!"*
> *-- M. Tadesse, Optimize-U Workshop Series-2012*

Bottom Line: The never-ending dilemma of the small business owner will continue as long as the circumstances remain unchanged—with the entrepreneur continuing to run into problems and asking the same old questions as: What should I do now? Who can I turn to? I am so stressed/desperate! And screaming the silent cry---"Help, please!"

The Owner's Dilemma Has Practical Solutions: Help is available, but you have to look for it!

The formula for success is the same for the billion-dollar company and for the small start-up; i.e. both need a great business idea, a good business plan, a passionate and determined entrepreneur, and a synergistic team of experts working together towards a common goal. While large companies and well capitalized start-ups have all these factors built into their overall infrastructure, this paper acknowledges the alternative reality of the average small business, especially in area of technical and strategic management expertise. The following is, therefore, intended to provide certain tactical strategies and alternative sources of senior expertise, without which the entrepreneur cannot fulfill the targeted business objectives.

Bottom Line: Starting a new business is like a journey to a faraway destination where you have never been before. One needs a very good road map or a GPS; but the best way is to have a guide who has successfully completed that same journey. What better guide for your new business than having a team of experts who have been there and done that? Not only will you benefit from their successful experience, you will also learn from their "lessons learned" from their mistakes. If you want to succeed, you should look for those pros/seasoned experts--learn from them; better still, get them on your team and let them optimize you. Granted, these resources can be expensive and not easily accessible, but our objective here is to highlight alternative ways that can make it feasible.

Alternative Resource Venues

There are several alternative venues for accessing expert help for your business venture, but you have to know what to look for and go after it diligently and deliberately.

The following provides some of the key venues along with the respective characteristics of each so you can understand the structural differences as well as purposes and objectives for which each may be best suited to help you take your business from where it is to where you are aspiring to get to.

Bottom Line: Business is a long journey to an unknown destination, and there is no short-cut to success. Getting lost is not a viable alternative either, and you need to get some good tour guides to show you the way. What better help than those who have been there and done that! .

Some of the major alternative venues available for entrepreneurs are:

1. Executive Mentor
2. Advisory Board
3. Executive Coach
4. Executive Consultant
5. Strategic Affiliates & Peer Groups

Bottom Line: While the above is by no means an exhaustive list, a combination of two or more of the above can make an incredible difference in your business progression and ultimate success. The key is to make sure that there is a good fit between your needs and the specific expert(s) you go after.

Certain Specifics About Each of the Top Four Alternative Resource Venues

1) A Mentor:

- Trusted advisor/coach/facilitator of success: your personal success is their goal
- Mentor/protégé (one-on-one) relationship—solid and usually long term
- A strong support system—based on two-way respect, trust and common goals
- A reliable and trusted resource that combines senior executive experience and success track in your business area as well as potential network of other high level contacts they can bring to you.
- A pivotal resource that is often identified as the key factor in many entrepreneurial success stories.

Bottom Line: A good mentor is an invaluable asset that helps optimize one's strengths as well as provide opportunities than one might not otherwise have. A mentor is a willing and highly potent resource that can facilitate your success, and such relationships must be carefully cultivated and valued to sustain the mentor's deep interest and commitment.

2) Advisory Board:

- A synergistic group of experts working as team
- Focus is on the business, and less on executive development
- Diversity of expertise in team is key; all bring high-level expertise
- Formal structure--easy set up but requires a diligent approach
- Different from formal board of directors—"advisory" implies that they do not have fiduciary responsibilities or enforcement power over your action
- They believe in your business idea and you; they see potential and believe they can facilitate success!
- May provide more than their expertise---their contacts, opportunities, networks, and can open doors to critical resources.

Bottom Line: A well-structured advisory board can be invaluable to a small business. Although they do not have power over the entrepreneur's actions and decisions, it is important that you demonstrate value to their input and follow their collective advice diligently. They must see results.

3) Executive Coach:

- One-on-one counseling arrangement with a senior executive expert resource
- Confidential and customized leadership and executive development
- The focus is on the executive, rather than the business
- Provides expert counseling focused on identified area of development
- Generally, a business arrangement—with clear and specific objective(s)
- Unlike mentoring, it is often structured and fee-based
- Clear objective, timeline and deliverable—with benchmarks and measurements
- Accountability for deliverables tied to specific objectives

Bottom Line: Executive coaching can be the preferred venue for a specifically identified leadership/management optimization or working through some specific identified challenge areas, again relative to you as a leader, entrepreneur and executive.

4) Consultant

- A non-employee, fee-based hired expert
- Typical focus is on business, not the owner/executive
- Outsourcing of specific task/project objective
- Flexible and negotiated fee structure
- Accountability with clear timeline & deliverables
- Independent and objective, free of any conflict of interest
- Typically based on a written contract
- Fee/payment structure often tied to results / deliverables
- Referral by their prior or current clients is important

Bottom Line: A consultant can be engaged on flexible fee structure--for a specific project, a defined time-frame, and on varying fee structure (hourly, project based, retainer+, etc.)

<u>Examples of Functions that can be Outsourced to Consultants:</u>

- Business plan and proposal writing; marketing, etc.
- Financial management, accounting, taxes, etc.
- Funding strategies, investments and loan acquisition
- HR functions – recruiting, hiring, training & development, payroll, etc.

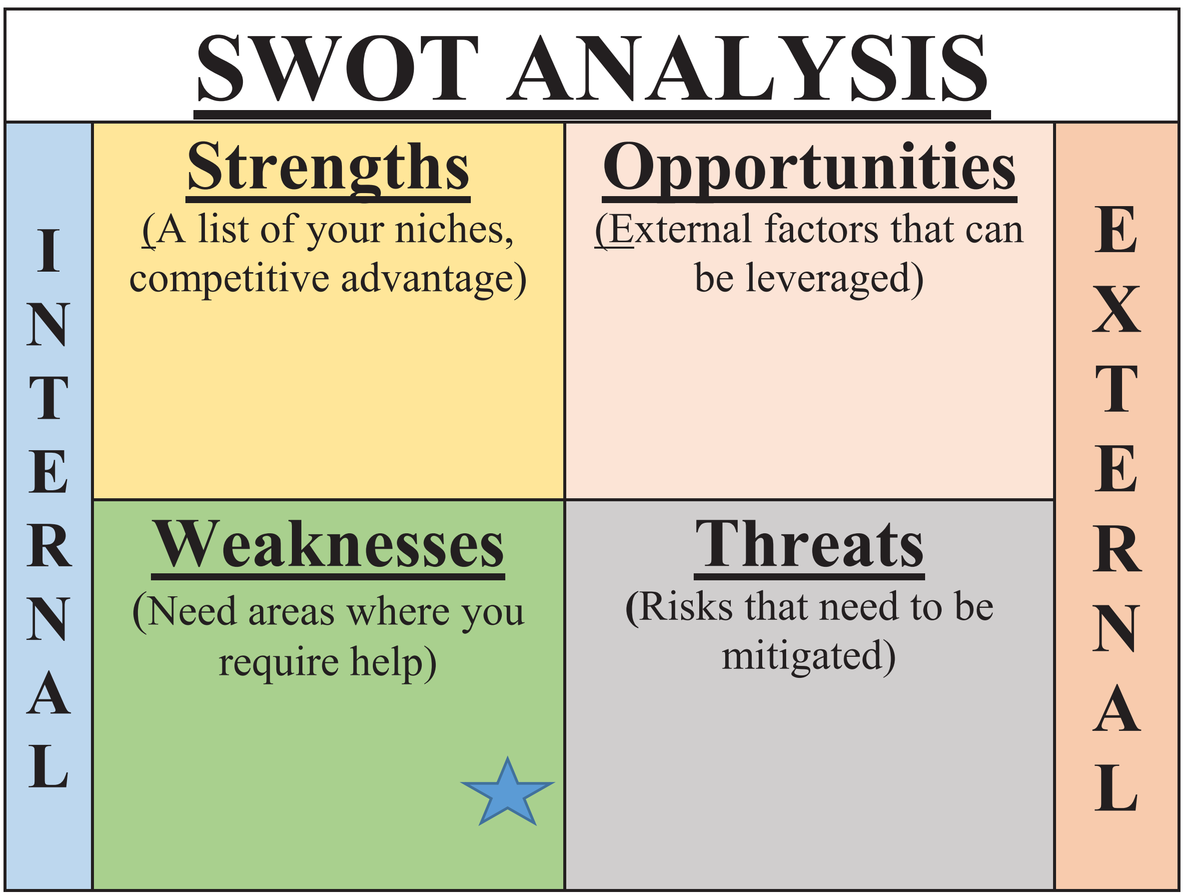
- Legal - contract and loan negotiations and administration, etc.
- IT services, website development, marketing packages, etc.
- Other functions where internal expertise is unavailable or insufficient

Bottom Line: Outsourcing of selected functions will not only free up owner to focus on core business, but it can also ensure the professional fulfilment of those functions.

Questions To Consider In Identifying and Selecting Your Experts//Team

1. **How does one know which alternative resource(s) to go after?**

Needs Assessment. The first step is to understand your specific situation so you can determine your critical need areas. A good approach is to do a SWOT analysis to identify your strengths and weaknesses, as well as opportunities and threats/risks that can impact your business objectives. Below is a simple template, and the key is to be diligent in going through the analysis so you can select the right experts to meet your needs as well as optimize your strengths and opportunities.



Bottom Line: If you are not clear about your core needs, it is possible to assemble an expert team that may not be the right fit, and even worse you may end up duplicating your expertise and potentially conflicting with your core objective, which can become costly and counter-productive. A case in point is a situation where business owners invite their colleagues and former classmates and workmates who may bring the same qualifications and experience as the business owner.

People also make a mistake by focusing solely on their business needs, only to find out that the world out there is similarly focused on solving their respective needs; i.e., your targeted experts have their needs and motivations.

Bottom Line Advice: Focus on your needs, as well as those of your targeted experts.

2. **Why do they want to be mentor/advisors? What is their motivation?**

Their Motivation May Be That:

- They want to give back to the community/part of their philanthropy work
- They want to be relevant, now that they may no longer work; or may just want to help future business leaders; and they see something in you
- They want to be part of a successful project/business
- Winners have a love affair with success—they may see this as an opportunity
- They develop a personal interest in your success
- They see high potential in your business plan or you individually
- Or, they may just like you and want to help you, etc., etc.

Bottom Line: The key is to be out there in clear view so you can see and be seen through the windows of opportunity. Be Strategic and Ready To Win Them! Follow Maslow's "Hierarchy of Needs Theory": Everyone has needs although the level may be different--FIND OUT WHAT THEIRS IS.

Certain Tactical Strategies to Attract High-Level Expert Mentors/Advisors/Coaches

- Have a good business idea and a great business plan
- Know what you want and where you are going
- Research and target your ideal experts
- Do your homework—Know what they want
- Go where they go and get them to notice you
- Be prepared—there are no second chances for a first impression
- Passion and enthusiasm is contagious—Wear it well!

- Impress them--You have to win their interest to help you
- Be passionate, prepared and likable!
- Keep a win-win focus: It cannot be all about you!

Bottom Line: Successful people are in love with success. Impress them with substance and get them interested enough to invest their expertise and time in you and/or your business. As the movie title goes: “If You Build It, They Will Come!”

Summary & Conclusion

Business is a team sport and success is the championship. No team with a single key athlete, no matter how great, can qualify to compete, let alone to win! Similarly, it is great to start your own business, but no single person can take a business to success all by oneself, no matter what! In both cases, a synergistic team of experts are needed to get to a win; and the number of experts and/or the degree of their expertise cannot be the sole focus either. It is also important to have a good fit and chemistry to build a winning partnership with your expert team.

Set clear and specific goals; identify your strengths and weaknesses; and make sure you acquire the appropriate expert help in areas of your critical needs. The goal is to have a cohesive and capable team that can work together to help you take your business forward and upward.

Here are some final words of advice from the author:

- ⇨ Expert help is critical – don’t try to do everything by yourself—It is inefficient, costly and may even be deadly in the long run!
- ⇨ You cannot afford not to afford good expert help—The right expert help will more than pay for itself!
- ⇨ Don’t try to be the business card CEO “Chief Everything Officer”---that’s a self-inflicted stress that will surely lead to “Burnout”—emotional and financial!
- ⇨ Don’t limit your success potential by not finding and working with key experts to help you get to your highest potential—It is possible.
- ⇨ Begin with a good SWOT Analysis to make sure you know what specific expert resource you need;
- ⇨ Make it a win-win. Do your homework about your target resource and their motivation (needs) so you can build a successful partnership that can be productive, exciting, successful and fulfilling for you and your expert resource team members.

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ROLE OF ETHICS IN CORPORATE GOVERNANCE

By: Steven J. Clarke, Royal Melbourne Institute of Technology and
Peng Chan, California State University-Fullerton

ABSTRACT

The issues facing board of directors require principles and values that can stand the test of time. With the fall of many high profile corporations and new reporting requirements, the attention and inclusion of ethics within corporate governance was inevitable. Perfection is futile, however when every issue and problem is examined through an ethical lens room for error and risky behavior is minimized. Assessing everything from the selection process, board composition, capacities and individual character of each board member are all imperative in establishing a strong, ethical functioning board. The benefits of incorporating ethics and ethical behavior as the standard for corporate governance cannot be underestimated.

INTRODUCTION

Corporate governance refers to the rules, policies, and legal and non-legal practices used to operate, control and direct corporations. The framework is supposed to ensure accountability, transparency and fairness. It also specifies and distributes rights and responsibilities among board members, senior executives, managers, directors, shareholders and stakeholders. Boards have a duty to ensure management is doing everything it can to maximize future value, and minimize and avoid present dangers. Corporate governance varies from company to company depending on the industry, type of business, size, geographic location, affiliations, and stakeholders among other things. The purpose of corporate governance is to increase accountability and avoid disasters before they occur.

The selection process for board membership is very important, and it can vary from company to company, but generally it's the same. Every board has a nomination committee, which is responsible for searching, researching and selecting individuals to become board candidates. However, all board members are encouraged to recommend potential new members. Once the board reviews the candidate's credentials, several committee members will meet with him or her along with the company's president and executive team. Once there is a general consensus, the candidate is presented to the board for approval and is voted in. A new board member goes through an orientation process in which he/she is formally introduced to the board of directors and based on his/her skills he/she is assigned to a committee. The board member receives plenty of information about the current status of the company, contact information and a meeting schedule. Board meetings are scheduled one or two years in advance and are usually four times a year.

The diversity of corporate boards is a crucial component to its functionality. Diversity is a highly discussed topic due to stakeholder pressures and the reality that even today very few women and minorities are board members. Many boards claim there is a lack of qualified diverse candidates. Other boards don't want to change their existing board structure and culture, and lastly some boards are simply not invested in creating diversity on their board. However, the benefits of a diverse board cannot be ignored. The decisions boards make affect individuals, businesses, communities, and countries. Everything from selecting the CEO, executive compensation, mergers, relocations etc. is decided and approved by a company's board of directors. Having a diverse board brings diversity of thought and skill. The "2020 Women on Boards" puts it this way, "Good corporate decision-making requires the ability to hear and consider different points of view, which comes from people who have different backgrounds, experiences, and perspectives. Companies that have women directors and executive officers lead by example. They send a clear message that they value diversity of thought and experience. Advancing women to positions of leadership is smart business." [1]

GOVERNANCE

Corporate governance has been under a lot of scrutiny due to the unethical behaviors of several high profile companies. However, corporate governance is not a new concept. The practices, processes and fiduciary responsibility of board members have been around for many years. Companies such as Enron, Tyco and WorldCom brought into question the neglect of boards, and the convoluted interests of some board members, which hinder transparency. Executive compensation, board composition and voting are just a few challenges boards are dealing with today.

The company's board of directors determines a CEO's compensation package. That is not an issue, but what happens when CEO's make 700 times more than the average worker even when a company is not doing well. The board of directors is comprised of executives who are well paid too so it makes sense that they will approve high salaries and compensations packages. Compensation analysts also contribute to the ongoing status quo of high CEO compensation by researching and analyzing peer firms and reporting their findings to the board. "For boards to change their stripes when it comes to executive compensation, major changes need to take place in who is on corporate boards and on their compensation committees. It would mean fewer CEOs on corporate boards. It would require more board members who understand talent management and are concerned about the societal impact of corporations. Another effective change would be to have a board membership that is dominated by strong, independent directors." [2]

The board culture, dynamics and history all come together to ensure a company is successful and transparent. However, dysfunctional boards exist too and the problems created by the politics, clout, and lack of skill in some instances is tragic. Corporations and its board members ultimately have the power to run a company as they wish, even if that means they run it to the ground. Voting doesn't mean anything if board of directors can ignore the votes. If the CEO and top managers are against the outcome of a vote such as a shareholder takeover, they can easily release more stock to dilute the price and shareholder power.

Directors who have served for a long time and no longer exhibit knowledge or strategic direction also hinder boards. However, boards are made up of peer groups and asking a director to step down is a challenging issue. The company's corporate bylaws outline mechanisms to formally remove a member from the board this is usually the last resort. The best outcome is if the director resigns. This decision is usually made after several committee members meet with the director and discuss the issues.

GOOD ETHICS IS GOOD BUSINESS

Today with the Sarbanes Oxley Act and the Securities Exchange Commission corporations have to meet governmental standards, which include a code of ethics. The pressure to demonstrate ethical behavior in business is not a trend. Enron, Tyco, and the Exxon Valdez and the BP disasters demonstrate the need for good ethics in business. Focusing on character as well as competencies when selecting new board members is a criterion that can't be ignored.

The SOX Act became law in 2002 after the accounting scandals of Enron and World-Com to ensure financial transparency and increase confidence in public company financial reporting. Although, SOX can't prevent accounting fraud it did achieve greater internal financial controls, it imposed new reporting structures, audit disclosure whistleblower structures and ethics requirements. The SOX Act made it clear to boards cannot fall asleep at the switch. The principles of good governance are held to a new level of accountability. SOX essentially empowered boards, encouraged the adoption of a code of ethics, it created the Public Company Accounting Oversight Board, created an SEC rule that requires companies to have an outside lawyer and an in-house counsel, increase the cost of running a company, it empowered the SEC and although private companies are not subject to SOX reform many have adopted the provisions as best practices.

Ethics is not the same as compliance. Compliance is obeying the law and ethics is simply doing the right thing. Attracting ethical board members is as important as attracting qualified board members. Making sure the capacities of a potential board member match the desired contribution to a board is essential in carrying out the business of the board. Selecting ethical board members ensures that ethical governance is practiced. Board members and senior executives have to model the way, or in other word's set the example. In today's business world board members carry the privilege and responsibility of being ethical leaders.

Corporate governance sets the tone for business strategies and stakeholder relationships. Therefore, business ethics begins in the boardroom. The board and the CEO are responsible for setting the ethical tone of the organization. This requires integrity and credibility on many levels. Board members must be able to demonstrate commitment to high ethical standards and hold management accountable. Establishing stakeholder trust and employee engagement ensures the continued success of a company. Social media and the interconnectedness of the business world suggest everyone is keeping a watchful eye on a company's performance, good and bad. Restoring and or keeping shareholder trust is an ongoing process. Therefore, a company's board, the CEO and management team have the obligation and responsibility to ensure the company's reputation is intact. Creating an ethical culture benefits everyone.

Character is not an elusive idea when it comes to ethics. A person's morals, values, standards, ethos and commitments represent aspects of a person's character. These qualities suggest a person will do the right thing. Being perfect is not the goal, striving for excellence based on time-tested ethical standards is. Therefore, what determines the character of an ethical person/leader? Based on over 30 years of research authors Kouzes and Posner suggest the following: leaders must be honest, forward thinking, inspiring and competent. [3] Leaders tell the truth, they provide followers with a future-focused vision, they provide inspiration with their energy and excitement, and they get things done in a competent manner.

There is sufficient research these days indicating that companies that a have a set of values and a culture of ethics are better performers. The common elements these companies share is going out of their way to please their customers; they are more generous to their employees, and their suppliers. Some of these companies include Costco, Southwest Airlines, Whole Foods and Patagonia. Companies stand to profit when they are known for acting with honesty and integrity.

CONCLUSION

Ethics is fundamental to the long-term success of a company; as such, ethics must be the guiding force of a company's governing board, its leadership and the day-to-day work of management. When people do their jobs responsibly and adhere to basic ethical principles, companies benefit on multiple levels. Shareholders and the company employees expect transparency, exemplary leadership, accountability and execution from top management and their board members. Joining a board is no longer a perk or an afterthought; it requires commitment and serious consideration of the responsibilities and implications.

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