# THE STANDARD STANCE

## Five Key Accounting Areas for Start-ups

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# FIVE KEY ACCOUNTING AREAS FOR START-UPS

Over the past few years, the Indian start-up ecosystem has witnessed significant growth, becoming one of the largest in the world. The unprecedented growth in start-ups has given rise to many innovative business models and the emergence of new financial instruments for funding their growth, which adds complexity to accounting. Additionally, when scaling up, start-ups often enter into unusual arrangements with customers, investors and employees that lead to some unexpected accounting outcomes.

While there could be some new/ unexpected accounting 'adventure' for start-ups to navigate, the 'famous five' accounting areas, enumerated below, would assist these organisations with common accounting challenges as they prepare for their growth journey.

We have also outlined solutions and best practices to avoid some common mistakes and effectively navigate the accounting complexities in respective areas.

## 1. Revenue recognition

For most start-ups, revenue serves as the critical parameter of their business health and often has the biggest impact on their valuation. Start-ups are often surprised by the complexity of determining the proper accounting for revenue, and the timing of recognising revenue ends up being different from what they originally thought.

Revenue recognition under Ind AS is complex and timely attention to the terms of contracts with customers can help manage the accounting outcomes, especially if the contracts are long-term. Additionally, start-ups seeking to use bespoke revenue arrangements with customers should fully understand the nuances therein, including the accounting treatment. The following table summarises some common challenges that start-ups face while applying revenue recognition rules under Ind AS and some practical solutions to overcome these complexities.

| # | Particulars | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 1 | Identifying distinct goods and services | Start-ups often provide bundled goods and services (e.g., sale of software, upgrades and support), thereby making it difficult to identify distinct goods and services in the contract with the customer. This identification (unbundling) is critical as revenue is recognised separately for each distinct good and service, which meets the definition of a separate 'performance obligation' as per Ind AS. | Understanding the terms of the contract and the start-ups' customary business practices is key to identifying distinct goods and services in the contract. In order to be 'distinct' as per Ind AS:<br>▪ Customers should be able to benefit from the good/ service on its own or with other readily available resources; and<br>▪ Good/ service should be separately identifiable in the context of the contract (Ind AS provides indicators to be considered for this assessment). |
| 2 | Determining expected revenue (transaction price) | For start-ups offering variable pricing structures and contingent settlement terms, estimating the expected amount of revenue becomes challenging. Additionally, start-ups may need to consider any non-cash consideration, consideration payable to the customer and significant financing component in the contract. | Start-ups should consider all forms of variable consideration (such as discounts, rebates, price concession/ escalation, bonuses, penalties, etc.) in the contract and estimate the same by applying the relevant guidance as per Ind AS. Variable consideration can only be included to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur in future. |

| # | Particulars | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 3 | Allocating revenue for each distinct good and service | Start-ups may lack historical data or comparable transactions to determine standalone selling prices for allocating the expected revenue to distinct good/ service in the contract. | Start-ups should consider their pricing policies and practices, and data used in making the pricing decisions, maximising the use of observable inputs (including prices charged by competitors) to estimate the standalone selling prices for its distinct goods and services. |
| 4 | Determining when to recognise revenue | Under Ind AS, revenue is recognised when control is transferred. New-age start-ups often provide products/ services or solutions that are unique and evolving (e.g., software-as-a-service, license or hybrid of both) and determining the point of transfer of control becomes even more judgmental and challenging. | Ind AS provides three specific criteria when control transfers over time. If none of these criteria are met, then the revenue is recognised for each 'performance obligation' at a point in time when control is transferred to the customer. There are specific rules if the distinct good is a license of intellectual property. |
| 5 | Principal versus agent considerations | Start-ups must carefully assess their role in the arrangement where multiple parties are involved to conclude whether they are acting as a principal or an agent for each distinct good/ service. | The determination of principal versus agent is critical as it will have a substantial impact on a start-up's top-line even if there is no major impact on the bottom-line. Each of the distinct goods or services in the contract should be assessed separately. Ind AS provides detailed guidance including indicators and examples to assist with the analysis. |

## 2. Funding - Debt versus Equity

Availability of finance is not easy for start-ups, especially those operating in niche markets. Often, convertible preference shares/ debentures are used as a source for start-ups to obtain financing for their operations because they typically involve lower cash outflows and are easier to issue in comparison with obtaining bank financing.

Many start-ups add enhancements to conversion features to attract investors as well. Debt-versus-equity determination is complex under Ind AS and unusual contractual terms in funding arrangements may have complex accounting consequences. Additionally, there are specific accounting rules for derivatives (or embedded derivatives) components in funding arrangements which must be fair-valued and can cause significant volatility in profit and loss.

The following table provides some common features of the funding arrangements (often in the form of convertible notes) which present specific accounting challenges for start-ups. We also outline some suggestions to navigate the complex accounting requirements in this area.

| # | Particulars | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 1 | Identifying contractual obligations | Due to the complexity of how the arrangement is structured, it becomes challenging to identify the contractual obligations for each component of the instrument to assess its accounting implications. | Each of the components of financial instruments is required to be analysed separately to determine its appropriate classification under Ind AS. Start-ups should understand the contractual terms and their accounting implications at the outset to avoid any surprises later. |
| 2 | Any buyback obligation | Investors consider their exit strategy when funding start-ups. Typically, such exit strategies could be in the form of a future public offering/ share sale. Some investors also prefer to have a right to call for buy-back/ repayment of the amount financed to safeguard their interests. This may result in unexpected accounting consequences if the terms are not reviewed upfront. | The key question to ask for a liability classification is whether the entity has a contractual obligation to deliver cash or another financial asset that it cannot avoid. In the case of buy-back rights, start-ups may end up having a contractual obligation to pay (even if there is no intention of the investors to exercise such rights). Hence start-ups need to review and assess the terms of buy-back at the outset to ensure understanding of accounting consequences. |
| 3 | Conversion terms | There are a variety of conversion terms in vogue nowadays to attract investors. While this may assist in getting funding from investors, the variety of terms increases the accounting complexity. | Conversion features in convertible notes often meet the definition of a derivative. They can only be classified as equity if they meet the 'fixed-for-fixed criterion' as per Ind AS. This is a complex area and hence specialist advice may help assess complex terms from an accounting perspective. |
| 4 | Dividend terms | Dividend terms may also result in accounting complexity, especially in the case of instruments that have both equity and debt features. | Some key terms relating to dividend rights to keep in mind for accounting purposes are (a) whether the dividends are mandatory or discretionary; (b) what is the basis on which dividends are determined and (c) whether the dividends are cumulative or non-cumulative. |
| 5 | Other contractual terms | The instruments may have various other terms requiring accounting assessment such as call and put options, anti-dilution features, down-round clauses, contingent settlement terms, etc. | Call and put options may result in embedded derivatives which need to be separately accounted for at fair value. Clauses relating to anti-dilution and down-round need to be reviewed to evaluate whether these are added to maintain the relative rights of shareholders and noteholders. Lastly, contingent settlement terms require careful analysis for appropriate accounting treatment. |

### 3. Share-based payments

Start-ups wanting to attract and retain best employees, but not having the liquidity, may do so by issuing shares. Share-based payments (which may be in the form of share options, share appreciation rights, etc.) also serve as a valuable tool to provide employees with a sense of ownership and commitment towards organisation goals. Investors are also particularly interested in share-based payments as these dilute the value of their existing shareholdings.

Under Ind AS, payment in shares is required to be recognised in the financial statements. The expense is measured using the fair value of the shares/ options. Accounting for share options and various schemes is complex and depending on the terms can have different outcomes. While accounting should not drive the commercial aspects of a transaction, it might be useful to consider if there are acceptable alternatives to achieving the same commercial imperatives while managing the accounting consequences.

Considerable care needs to be applied in evaluating the requirements set out in Ind AS to increasingly complex and innovative share-based payment arrangements. The following table provides some key accounting challenges for share-based payments and some accounting considerations to be kept in mind while using such share-based payment schemes.

| # | Particulars | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 1 | Shareholder versus employee | Some share-based payment transactions are not in the scope of the share-based payments standard of Ind AS such as when the transaction is in the capacity of a shareholder (and not an employee). This determination may not always be straightforward for start-ups. | Sometimes when employees are also shareholders, it becomes difficult to determine in which capacity they are acting in the transaction. The presence of specific conditions and restrictions such as relating to transfer of shares, buy-back or leaver clauses may indicate that employees are not acting as shareholders. |
| 2 | Classification – equity settled or cash settled | Because of differences in their measurement requirements, the incorrect classification of a share-based payment as equity-settled instead of cash-settled can lead to significant errors in the financial statements. Some share-based schemes also allow options for settlement which increases complexity in their accounting. | Share-based payment transactions are classified based on whether the entity's obligation is to deliver its own equity instruments (equity-settled) or cash or other assets (cash-settled). In some cases where share-based schemes are offered through other entities in the group, the classification of such schemes and thereby their accounting may vary for different entities. |
| 3 | Conditions attached | Share-based payment transactions are often conditional on the achievement of specified conditions (service condition, performance condition - market or non-market, etc.). Ind AS provides detailed guidance on distinct types of conditions and their accounting treatment. | Distinct types of conditions affect the amount and timing of accounting differently. Accordingly, appropriate classification of conditions as per Ind AS is important to ensure appropriate accounting. |
| 4 | Modifications of equity-settled schemes | Due to the dynamic business environment in which start-ups operate, modifications to share-based payments are a common phenomenon. Under Ind AS, modifications to equity-settled share-based payments are accounted for only if they are beneficial to employees. | As a basic principle, start-ups cannot reduce the share-based payment cost by modifying or cancelling a share-based payment. However, the timing may change based on the terms of modifications. |
| 5 | Fair valuation | For start-ups, the valuation of share-based payments is inherently complex due to the dynamic nature of their business and the subjectivity involved in key assumptions. In addition, the specific conditions attached to the scheme may add further complexity to the valuation of share-based payments. | Ind AS provides limited guidance on the fair valuation of share-based payments. Considering the complexity involved, specialist advice should be considered for fair valuation of share-based payment transactions. |

## 4. Partnerships and acquisitions

Start-ups routinely enter into partnerships and acquisitions to grow their business, through acquisition and diversification of products, resources, customers and markets. Some partnership arrangements may fall into the definition of 'joint arrangements' and others may come under the purview of 'business combinations' under Ind AS.

The accounting requirements for joint arrangements and business combinations are overly complex. Based on the terms of the arrangement, start-ups may need to account for the partner or acquired entity as a joint venture, associate or subsidiary with distinct accounting requirements. Accounting for acquisitions could equally be challenging depending on the terms of shareholder agreements and the mode of consideration.

Start-ups must be conscious of the critical accounting challenges arising from partnerships and acquisition activities to carefully plan and negotiate the related contractual arrangements. The following table provides some common accounting issues and challenges faced by start-ups while entering into such activities and some practical solutions to overcome them.

| # | Particulars | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 1 | Joint arrangements – joint operation or joint venture | There are two types of joint arrangements for accounting under Ind AS - joint operations and joint ventures. Determining the appropriate accounting treatment for joint arrangements is judgmental and often challenging, including assessing the rights and obligations of the parties and determining the nature of their involvement in the arrangement. | Classification of joint arrangement depends on the investor's rights and obligations. Joint operators have rights to assets and obligations for liabilities. Joint venturers have rights to net assets. Joint operations are accounted for by recognising the operator's relevant share of assets, liabilities, revenues and expenses. Joint ventures are accounted for using equity accounting as per Ind AS. |
| 2 | Acquisitions - asset acquisition or business combination | As per accounting guidance, acquiring a company does not necessarily mean that a 'business' has been acquired. If not a business, the acquisition will be accounted for as an 'asset acquisition' and accounting requirements are quite different in both cases. | The distinction between asset or business acquisition is important as it could have a material impact on the post-acquisition profit or loss, as well as on the balance sheet. Ind AS provides detailed guidance and an 'optional concentration test' to determine if a business has been acquired. |
| 3 | Recognition of new intangibles on acquisition | Often new intangibles are recognised on acquisitions. Identifying such new intangibles becomes challenging especially if detailed reliable information is not available with the acquiree. | Ind AS provides detailed guidance on the recognition of intangibles on acquisitions including examples. Understanding the business and key contracts and relationships of the acquiree is often useful in identifying relevant intangibles for accounting purposes. |
| 4 | Determining fair value for measurement | Start-ups often face challenges in determining appropriate fair value for identifiable assets and liabilities. This becomes more difficult for measuring intangibles such as brands and customer relationships which may require specialised valuation techniques. | While Ind AS provides guidance on fair value measurements, it is often useful to engage with valuation specialists to navigate through the specialised valuation techniques. Using a scenario and sensitivity analysis on key assumptions and projections is also advisable for assessing the reasonableness of the valuation outputs. |
| 5 | Earn-outs and contingent consideration | Earn-out arrangements are a common feature in acquisition transactions for start-ups. This gives rise to contingent consideration measured at fair value. In some cases, the earn-outs are also tied to the continued employment of the selling shareholder which may result in complex accounting adjustments. | Careful consideration should be given to the commercial terms of the arrangement. Earn-outs are often tied to revenue targets and revenue recognition is a complicated area in accounting terms. It is important that the accounting for earn-outs is clearly understood to assess its fair value measurement and accounting consequences. |

### 5. Development of intellectual property

Start-ups often bring in innovative business ideas and develop Intellectual Property (IP) for their competitive advantage and growth. Considering the dynamic business environment and limited resources with start-ups, it is challenging to effectively identify, protect and manage IP assets.

The accounting rules require expenditure on the research phase of an internal project to be expensed as incurred. When future economic benefits become more apparent as a project progresses into the development stage, capitalisation may be allowed on a prospective basis on meeting specified criteria. There is often no clear distinction between the research and development phases and no definitive starting point for capitalising such internal development costs. Therefore, there will likely be significant management judgement involved, based on the facts and circumstances of each project.

Ind AS requires recognition of an intangible asset arising from development or from the development phase of an internal project if, and only if, all of the specified criteria can be demonstrated. The following table summarises these criteria, the unique accounting challenges faced by start-ups against such criteria and some practical solutions to overcome them.

| # | Criterion | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 1 | Technical feasibility of completing the project | Meeting the technical feasibility is often the most difficult hurdle for start-ups developing new technology or IP. In regulated industries such as pharmaceuticals, this might come quite late when the start-up files for regulatory approval. | It is useful for start-ups to prepare a project document including the following details:<br>▪ Identifying the need for and benefit of the new technology/IP;<br>▪ Details of research on other available technologies in the market (including those used by competitors);<br>▪ Alternative designs/ types of new technology and recommendations for the suggested technology;<br>▪ Inputs and clearance from the development team on design and technical feasibility; and<br>▪ Broad project plan with indicative timelines, resources required and risk assessment. |
| 2 | Ability to use or sell and generate future economic benefits from the project | This requirement can be particularly challenging for start-ups in the early stages of development where there might be low certainty of future economic benefits. | To meet this criterion, start-ups need to demonstrate the future economic benefits of the project. This could be achieved with supporting evidence comprising one or more of the following:<br>▪ Details of internal/ market survey on potential benefits from the project;<br>▪ Inputs from users/ customers and their in-principle approval on the design/ expected project output;<br>▪ Customer inquiries/ feedback/ minutes of meetings, as available; and/ or<br>▪ Measurement of expected benefits from the project in terms of cost savings or future revenues. |

| # | Criterion | Challenges | Solutions/ Best practices |
|---|---|---|---|
| 3 | Availability of technical, financial and other resources to complete the project | It is often difficult to obtain funding for the development of the intangible asset until the point the technology has been proven to be feasible. Further, start-ups often find it challenging to get the required workforce and other resources to complete the project. | Depending on the size and complexity of the project, this would prove to be one of the most significant challenges for start-ups. To meet this criterion, the start-up may evidence the following:<br>▪ Detailed project plan for development with assigned responsibilities and timelines;<br>▪ Detailed budget for the new project with a breakdown of costs and other resources required for completion; and<br>▪ Availability of sufficient funds to finance the development project and other required resources to complete the project. |
| 4 | Reliable measurement of the expenditure attributable to the project | For start-ups, the significant development expenditures are likely to be internal costs such as employee, IT, etc. It might be challenging to reliably ascertain the costs attributable to each specific project and distinguish it from ongoing business operations. | The ability to reliably capture the costs incurred on the project is critical for any asset capitalisation. For development projects, start-ups need to have the proper systems, processes and controls to identify, isolate and monitor the directly attributable costs. It is useful to assign a unique project code for each project with a detailed breakdown of budgeted costs and then have the process and controls to ensure the booking of expenses against respective components. Regular monitoring of costs incurred against budgets helps ensure reliability and appropriate control over costs incurred for respective projects. |
| 5 | Intention to complete the project and use or sell it | After meeting the above four challenges, this might not be a significant challenge for start-ups apart from ensuring that the senior management is committed towards the project and the project remains on track as expected. | The project needs to be approved by the appropriate management personnel to demonstrate the intention to complete and use or sell the output from the project. In addition, there should be a regular monitoring of all the above four criteria to ensure that necessary updates are made, and project objectives are expected to be met at all stages. |

## Concluding remarks

Start-ups are typically more focused on building their business and raising capital and sometimes tend to view financial reporting as compliance. However, this could prove to be a mistake, especially when it comes to financing and scaling up.

A start-up business owner may not have to prioritise accounting decisions over business decisions, but it helps to learn about their impact on each other. This can help in their negotiation with investors and stakeholders more effectively. Reliable financial reporting will also help investors and other stakeholders to have confidence in a start-up's business and keep them on board for continuous growth in the long run.

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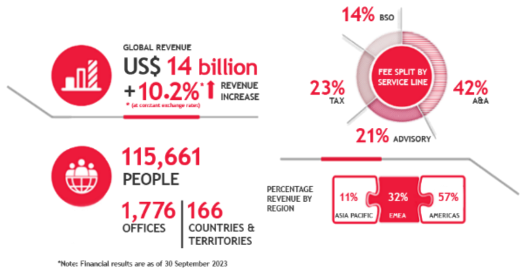


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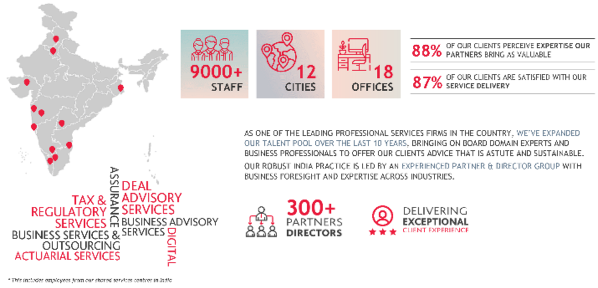


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