Industry Canada Industrie Canada

Self-Study Guide

STEP 2:
Know Your Financing Options

Canada

STEP 2:

Know Your Financing Options

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2.1 Know Your Financing Options - Introduction

By now you should have a good idea of how much money you need to finance the cost of expanding your business. But where will you find the capital? You should look at three possible sources of funds: internal, conventional external and risk capital.

1. Internal Sources

Begin by looking inside your own company. Can you make funds available by increasing your company's efficiency? For example, can you negotiate better terms with your suppliers, or lower your accounts receivable and inventory to free up working capital?

2. Conventional External Sources

Next, look for funding from conventional sources, such as your bank. Lines of credit, long-term and short-term loans, and mortgages are examples of conventional financing.

3. Risk Capital

Finally, once you've explored both internal and conventional sources, then consider risk capital financing. At this point, too, you'll need to look at your overall capital structure.

How One Company Used All Three Sources

New Tech Distributors Corp. (New Tech) is our case example company. It needs $1,575,000 to cover the costs of expansion. The owners are going to use a mixture of sources to get the capital they need: $775,000 from internal sources, $200,000 from conventional sources and $600,000 in risk capital (in the form of equity).

New Tech's Funding Sources	
Internal sources: cash flow and operating line	$775,000
Conventional external source: bank loan	$200,000
Risk capital financing: equity	$600,000
Total	$1,575,000

In This Step

You'll learn about the different types of financing options open to you, and the different uses and merits of each on the following pages:

- Understand Conventional and Risk Financing
- Know Your Options
- Sort Through the Pros and Cons
- Explore Capital Structures
- Choose the Right Capital Mix
- Consider the Entrepreneur and Investor
- Action Items

The New Tech Story

Follow the fictional company New Tech Distributors Corp. (New Tech) as it pursues venture financing. This case example gives you a feeling for the "real" data and strategic decisions you'll be facing.

2.2 Understand Conventional and Risk Financing

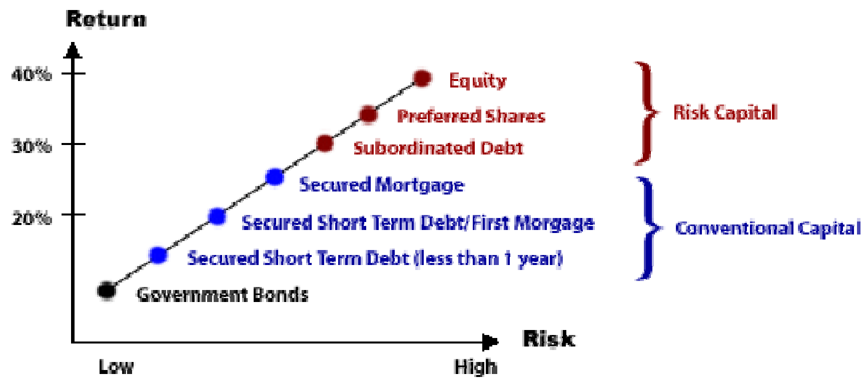
You have two basic external funding sources: conventional capital and risk capital. Each option bears a different cost. And risk is the key to determining what the cost will be to finance your growing business.

Conventional sources lend at lower rates but impose restrictions to lower the lender's risk. So, for example, when you seek capital from banks and other conventional sources, you may find constraints placed on your borrowing. Maybe the size of your operating line of credit will be restricted, or the amount of your term debt will be limited.

Risk capital sources will fund businesses that conventional sources will not finance. But they will only do so for a price. They will expect a higher rate of return to compensate for the higher risk.

Risk and Rate

Simply put, risk and rate (that is, rate of return for the investor) go hand in hand. As risk goes up, so does the rate. Why? To compensate for the investor's additional risk. And a higher rate of return means a higher cost to you, to finance your investment needs.



Check It Out

Check your understanding of risk, return and funding options by answering these questions. See answer on page 6.

1. Why do many companies consider equity the most suitable option, when it commands such a high rate of return?

2. Which providers of capital prefer lower risk investments? Which ones are willing to take the higher risks for higher returns?

3. What are some factors that determine whether risk is higher or lower?

Tip

Investors consider different types of risk when choosing how to invest. Here are the descriptions of the three basic types of investment risk.

Three Types of Risk
Investors consider different types of risk when choosing how to invest.

Business risk: This is the predictability, stability and level of future net cash flow. The more uncertainty there is in forecast cash flow, the riskier the investment.

Financial risk: Different types of investment have different amounts of "financial leverage" or level of claims on net cash flow. For example, interest-bearing investments have a claim on net cash flow and therefore represent a lower risk for the investor.

Instrument risk: Different types of financial "instruments" have inherently different levels of risk. For instance, a secured debt has less risk than an unsecured debt because the borrower has a greater obligation to repay.

Answer to the questions (from page 5)

Question 1:

Why do many companies consider equity the most suitable option, when it commands such a high rate of return?

Although equity commands a high return, it's often the most stable and appropriate source of capital for a growing company. That's because when you're dealing with a risk capital investor, the annual cash cost for the equity may be very reasonable. It's the market (i.e. initial public offering) that will pay the price at "take out" time, that is, when the investor exits your company.

Question 2:

Which providers of capital prefer lower risk investments? Which ones are willing to take the higher risks for higher returns?

Conventional (low risk) Investors

- commercial banks
- credit unions
- trust compagnies

Risk Capital (higher risk) Investors

- finance compagnies
- angel investors
- private venture capital firms
- institutional and labour-sponsored funds
- government and corporate strategic investors

Question 3:

What are some factors that determine whether risk is higher or lower?

Some Risk Factors Investors Consider

- How large is the amount of money involved?
- When will the investment start to produce a return?
- How long until the funds will be fully repaid?
- What security (collateral) is there, in case of problems?

2.3 Know Your Options

The two sources of funding (conventional and risk) can be further broken down into short-term and long-term financing. A growing company looking for financial help can consider four categories: short-term and long-term financing, from both conventional and risk lenders. And within each of these categories there are even more options.

In your previous business experience, you've almost certainly tapped into one or more specific types of financing that fall into these four categories. Have you ever used a line of credit from your bank, for example? Then you've used conventional short-term financing. If you've leased a car, then you've used conventional long-term financing. Take a closer look in the Appendix, it contains in-depth information about the four different types of external funding sources.

Risk Capital Long-term Financing • Equity • Subordinated Debt	**Risk Capital Long-Term Financing** Risk capital investors invest in equity shares and equity-related debt in relatively small or untried enterprises, thereby taking a risk that commercial lenders won't usually shoulder. Risk capital investors are rarely interested in inventions that need further research, development and engineering. These investors provide primarily equity financing, but they may also provide debt financing in the form of quasi-equity.
Conventional Long-Term Financing • Term Loans • Leasing • Mortgages	**Conventional Long-Term Financing** Capital assets or fixed assets are often bought through intermediate and long-term financing. Straightforward term loans, usually secured by the capital asset itself, are one example. Equipment vendors and leasing companies also provide financing through leasing arrangements. Lending institutions such as life insurance companies, commercial finance companies, pension funds, and federal and provincial government agencies provide longer financing on capital assets.

Risk Capital Short-Term Financing • Asset-Based Lending • Factoring	**Risk Capital Short-Term Financing** Like banks, commercial finance companies provide credit on working capital accounts such as accounts receivable and inventories. These lenders are more concerned with the quality of the underlying collateral than with the credit worthiness of the borrower. Because of their expertise with receivables and inventory-based loans, these lenders can frequently advance to the borrower a higher percentage against the collateral.
Conventional Short-Term Financing • Bank Line of Credit • Supplier Credit	**Conventional Short-Term Financing** Conventional short-term financing is usually provided by commercial banks and is repaid through inventory turnover or by converting receivables to cash within the time frame of the loan. Your bank will lend your business money if it feels comfortable with the risk. Loans may be secured (backed by collateral) or unsecured (backed by the lender's confidence in you).

2.4 Sort Through the Pros and Cons

Advantages and Disadvantages for the Entrepreneur

As you've seen, there are many options for funding your business's expansion. And each option has pros and cons to consider.

Risk Capital Long-Term Financing

- Equity
- Subordinated debt

Conventional Long-Term Financing

- Term Loans
- Leasing
- Mortgages

Risk Capital Short-Term Financing

- Asset-Based Lending
- Factoring

Conventional Short-Term Financing

- Bank Line of Credit
- Supplier Credit

Equity

Advantages	Disadvantages
• Low financial risk. No obligations for cash payment. • No restrictive covenants that could cause default. • Provides stability and permanency. • Investors generally seek to realize on their equity investment in the marketplace (i.e. at no cash cost to the company).	• Dividends are not tax deductible. • Dilutes your equity interest. • Takes time to access. • Loss of voting and, potentially, management control. • Set-up costs are high.

Subordinated debt

Advantages	Disadvantages
• Flexible and can be tailored. • Less expensive than equity. • Fills a financing gap and high leverage is available. • Not as much dilution as straight equity. • Available to a variety of industries.	• Takes time to access. • Expensive relative to other sources of short- and long-term financing. • Some cash flow servicing requirements. • Investors will take a more active role in your company than other lenders. • Set-up costs are high. • Restrictive covenants often apply. • Does not provide the stability of equity.

Term loans

Advantages	Disadvantages
• Longer repayment terms. • Easy access. • Flexibility. • Tax deductibility of interest. • Suitable for long-term needs: permanent current assets and fixed assets. • Low cost relative to other long-term sources of financing. • Commits the lender for a long term. • Does not dilute equity.	• Ties up your assets. • Increases your financial risk given the cash payments of interest and principal. • Commits you: prepayment will be subject to penalties. • Often includes restrictive covenants. • You may not have suitable security to offer, or your business/financial risk may be too high.

Leasing

Advantages	Disadvantages
• Up to 100% of the asset cost can be financed. • Terms may be longer than term loans because you can tailor the lease to the life of the asset. • Maintenance and other services are provided. • Cancellation options are available. This may be beneficial where technology is advancing quickly. • Lease payments are tax deductible. • The cost may be comparable to a term loan (the lease payments will include an implied rate of interest), but the legal cost to set the lease up should be less. • Limited restrictive covenants. • Does not dilute equity. • Flexibility. You may have limited needs (e.g. two years) but the asset life is less than 10 years. You can structure the lease around your limited needs.	• If you default on your payments, it is quite easy for the lessor to walk in and legally remove a potentially critical piece of equipment used in your operation since the lessor owns the equipment. • Increases the financial risk due to the fixed stream of cash payments. • Cancellation costs are high.

Mortage financing

Advantages	Disadvantages
• Long-term commitment, without equity dilution. • Maturity matches the long life of the asset. • Interest is tax deductible. • Relatively inexpensive source of long-term financing. • Easy to access. • Considers the value of the asset, more than the value of the business. • Standard documentation requirements. Restrictive covenants will be basic.	• Fairly rigid instrument. • Increases financial risk due to fixed stream of interest and principal repayments. • Committed, repayment will hold penalties.

Asset-based

Advantages	Disadvantages
• Ideal for growing, highly leveraged and turnaround situations, because of the higher level of risk assumed by the lender. • No complicated financial covenants, which require monitoring and compliance. This results in less chance of default under a loan agreement. • Given the heavy reliance on the value of the collateral, it increases the opportunity for leverage. • Lowers the need to raise equity, avoiding equity dilution. • Interest is tax deductible. • Easy to access.	• Not suitable for all industries; needs high levels of receivables and inventories. • Increases your financial risk, due to interest servicing. • More expensive than conventional short-term financing. • Onerous inventory and receivables monitoring requirements, sometimes as often as daily.

Factoring

Advantages	Disadvantages
• Factors assume the risk of your receivables but not your business/financial risk. Therefore, financing is accessible even if your company's overall risk is relatively high. • Increases the turnover of your accounts receivable, in turn increasing the amount of available working capital and, therefore, reduces other financing requirements. • Lowers administrative duties and costs. The factor may assume collection, booking and reporting. • May protect your company against bad debts. • Suitable to finance temporary working capital and offset permanent current asset requirements.	• If the volume of your receivables is low, your situation may not be suitable. • Relatively expensive, particularly when invoices are numerous and small in dollar amounts. • Not commonly accepted in many industries. • Not suitable for most long-term needs. • Possible negative impact on customer relationships.

Bank line of credit

Advantages	Disadvantages
• Easy and fairly quick to access. • Relatively inexpensive. • Flexible. • Facility revolves up and down, maximizes cash management. • Suitable for short-term temporary needs. • Usually, reporting requests are minimal. • Negligible effect on control and ownership. • Interest/fees are tax deductible.	• Increases your financial risk, cash servicing required • Amount available is limited by the ceiling. • If you are experiencing problems, lender is in a position to demand/cancel the line, or realize on the security. • Not suitable for long-term requirements, where you expect returns over a long period. • You may not have suitable security, or your business/financial risk may be too high.

Supplier credit

Advantages	Disadvantages
• Very inexpensive source of financing. • Very limited documentation required. • Easy access. • No costs. • No controls. • No security.	• Likely not sufficient to bridge fully the timing difference between paying for supplies and receiving cash from sales. • Very short term in nature. • If you do not pay on time, the supplier might cut off future supplies, which could have adverse effects on your business.

Entrepreneur Stories

Giving Up Control

Are you ready to give up some control in exchange for equity financing? Here’s how Bfound.com approached the problem.

Exchanging Control for Growth Potential

Many entrepreneurs may be reluctant to make the concessions needed to obtain venture capital, but not the owner of Bfound.com. He understood that in order to take the company to the next level, he would have to give up some control. He then had to convince his partners that this was the right path. As one partner put it, giving up some control of the company requires a shift in mindset. But Bfound.com wanted more than money. It was looking for a partner who would invest knowledge and contacts. Unlike some entrepreneurs who may be nervous about taking on an active investor, Bfound.com appreciated the advantages that such a partnership could bring. In the end, Bfound.com's owners found that giving up some control let them acquire the capital they needed. The company succeeded in three rounds of financing. In the first round an active private investor brought in management expertise and $750,000 to fuel Bfound.com's near-term growth. In the second round two private investors and a venture capital firm provided $1 million. In the third and final round Bfound.com was bought, for an undisclosed sum, by a large U.S.-based software applications developer.

2.5 Explore Capital Structures

Capital Structure and Mix

With such a range of short-term and long-term financing options available, how do you choose the right ones for your company? Making decisions about capital structures is a starting point.

Your firm's capital structure is determined by the proportion of:

- external to internal sources;
- short-term to long-term financing; and
- debt to equity.

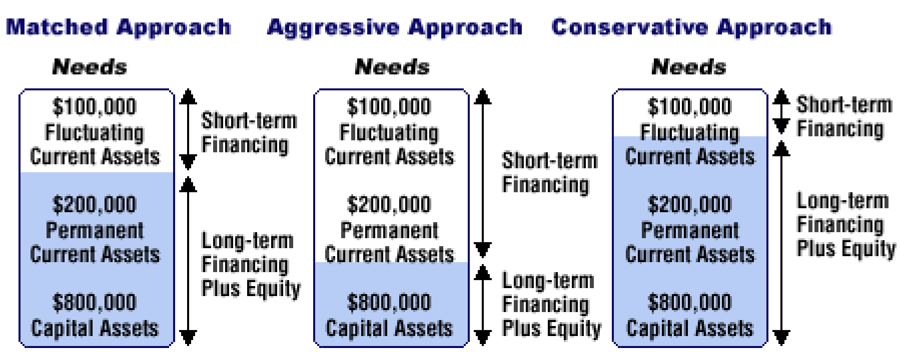
For example, consider a company that needs $1 million to buy assets. Specifically, the company needs:

- $100,000 to fund fluctuating current assets (short term);
- $200,000 to fund permanent current assets (long term); and
- $700,000 to finance capital assets (long term).

How should the owners finance these needs?

They can choose to match the "life span" of the financing sources with that of the funding needs. In other words, they can match short-term needs with short-term financing and long-term needs with long-term financing. Or, they can choose a "mismatched" approach where financial needs and funding sources don't have similar terms and maturities. The table below illustrates three options.

Approaches to Capital Structure



Short-term financing is used for short-term fluctuating needs.	Short-term financing is used for fluctuating and permanent capital needs.	Long-term financing (i.e. debt and equity) is used for fluctuating and some permanent working capital needs.
Long-term financing (i.e. debt and equity) pays for permanent working capital and fixed assets.	This strategy is "mismatched" because a large portion of long-term needs is funded by short-term financing.	This strategy is "mismatched" because short-term needs are funded by long-term financing.

FAQ

Which to choose: risk capital or other financing options?
Here are some guidelines to help you determine the right capital mix and structure.

Consider These Guidelines

When choosing how to balance your use of risk capital and other financing options, consider these guidelines.

1. *Equity or debt?* As the risk of the investment goes up, the investor requires a higher rate of return. The shift of risk from your company to the investor increases the cost to your company.

However, if equity risk capital is raised, there is generally little cash cost to the company because the investor will hold the equity for a number of years and then sell the shares in the market place.

Of course, there is an opportunity cost (i.e. the value of the shares when they are sold). The company may have been better off with more equity, but this is often offset by the additional benefits equity risk capital provides to a growing company.

2. *Risk and cost.* As risk of the investment goes down, the investor requires a lower rate of return. This means the company is assuming a higher risk at a lower cost.

3. *Term and risk.* Short-term financing poses the lowest cost. But from your company's perspective, it holds the highest level of risk.

2.6 Choose the Right Capital Mix

Mix of Debt and Equity
The mixture of debt to equity is a key aspect of a firm's capital structure. Since giving up equity means giving up "control" in some sense, the debt to equity mix is sometimes described as being high or low "leverage." When you finance with debt, you retain equity and control; so you, as the owner, maintain more leverage. On the other hand, when you finance with a high proportion of equity, you give up some control and therefore have less leverage.

- **High leverage**: Debt financing covers the bulk of your needs.
- **Medium leverage**: Equity and debt financing are balanced.
- **Low leverage**: Equity investments fund the bulk of your needs.

How a Company Decides on Its Mix of Debt and Equity Financing
In choosing the right mix of debt and equity, you must consider three issues: your projected cash flow to repay debts, the relative cost of the different types of financing, and the impact of sacrificing some ownership and control. For example, the high leverage approach (where you borrow to fund your expansion) may not be possible if you don't

have adequate cash flow to pay back what you borrowed. On the other hand, the low leverage approach (giving up equity in your business) may not appeal to you.

Choosing the Right Mix

Here is an example of how a company makes a decision on its mix of debt and equity financing. Imagine the company needs $1 million; it's buying equipment worth $900,000 and needs additional permanent working capital of $100,000. Consider the information, and decide which of these three approaches is best for this firm:

- high leverage (100% debt);
- medium leverage (60% debt/ 40% equity); or
- low leverage (100% equity).

Data

The useful life of the equipment will be 15 years.

Net Cash Flow Forecast ($000*)*

	Time Zero	Year 1	Year 2	Year 3	Year 4	Year 5
Net Cash Flow	($1,000)	$200	$200	$200	$200	$200

The cash flow calculations assume that term debt is borrowed at 15% and subordinated debt at 10%.

Option 1 – High leverage: 100% debt ($000)

• $325,000 (subordinated debt) $675,000 (term debt)

	Year 1	Year 2	Year 3	Year 4	Year 5
Net Cash Flow	$200	$200	$200	$200	$200
Interest	(134)	(122)	(110)	(95)	(80)
Cash Available for Debt Repayment	66	78	90	105	120

Option 2 – Medium leverage: 60% debt/40% equity ($000)

• $600,0000 (five-year term debt) $400,000 equity

	Year 1	Year 2	Year 3	Year 4	Year 5
Net Cash Flow	$200	$200	$200	$200	$200
Interest	(90)	(75)	(60)	(40)	(20)
Cash Available for Debt Repayment	110	115	140	160	180

Option 3. Low leverage: 100% equity ($000)

• $1,000,000 equity

	Year 1	Year 2	Year 3	Year 4	Year 5
Net Cash Flow	$200	$200	$200	$200	$200
Cash Available for Debt Repayment	$200	$200	$200	$200	$200

Which would you recommend?

- High leverage (100% debt)
- Medium leverage (60% debt/40% equity)
- Low leverage (100% equity)

Choose an answer and check below your choice.

High leverage (100% debt)

High leverage is not the best choice.

There is insufficient cash flow in the high leverage situation to repay the term loan in five years. This scenario is far too risky for the owners. They need to give up some amount of ownership in exchange for the capital they need to grow.

Medium leverage (60% debt/40% equity)

Medium leverage is the best choice.

The cash flow is easily available to repay the debt, and the owners maintain control.
The $600,000 term loan is not too risky because it represents two thirds the value of the equipment. Total cash flow available to repay debt is $715,000 against the $600,000, giving a 19% margin. And the life of the asset extends to 15 years, leaving 10 years to provide a return on the equity.

Low leverage (100% equity)

Low leverage is not the best choice.

With $200,000 net cash flow each year, the company would not want to dilute its equity position to the degree required under the low leverage scenario. The owners would be giving away more control than they need to. They've got the cash flow to take on more of the risk themselves in the form of long-term debt.

2.7 Consider the Entrepreneur and Investor

Financing options and capital structure and mix must suit both owners and investors. In thinking of how to approach potential investors, consider both:

- entrepreneur’s considerations
- investor’s considerations

What to Consider From Your Perspective

Which approach — matched, aggressive or conservative — is best suited to your company? Which mix of short-term and long-term obligations and of debt or equity financing best meets your needs, goals and constraints? Which is more suitable: high, medium or low leverage? The answers depend on several factors.

Costs

The more debt you assume, the bigger your fixed cash servicing burden. However, the actual cost of debt is lower than the cost of equity.

Risk

If you add more debt to your company, you're adding risk because you lock the company into scheduled interest and principal payments. If you default on a loan agreement, the lender may force you into liquidation or bankruptcy.

Options to Protect Your Downside Risk

If you're in a cyclical industry, consider using more equity. If your company or project is very sensitive to increases in interest rates, consider using fixed rate, long-term financing or interest rate protection products. If you have a ratchet clause as part of your financing agreement, protect your downside risk. Ensure there is a ceiling on how much equity the investor can own if you don't meet your projections.

Relationship With Third Parties

A private equity investor will probably want greater management and decision-making involvement in your company than other types of investors. Some debt arrangements hold onerous reporting requirements (e.g. asset-based lenders may monitor your inventories and receivables as often as daily). Can you live with these arrangements?

Collateral

Providing assets for collateral ties up the asset for future financing. If an asset secures debt, the lender might seize that asset in the event of default. The leasing option is particularly vulnerable in this respect. And there may be pre-existing contractual constraints that limit the types of funding you can pursue.

What to Consider From the Investors Perspective

To assess whether your investment opportunity will meet a prospective investor's criteria, consider these issues. (Some of them are dealt with in other Steps.)

Rate of Return

Determine if your company can generate a sufficient rate of return on the investment (an equity investor will usually require a minimum return of between 25% and 40% per year). Assess if the rate of return is appropriate with the overall level of risk.

Control

Some investors require a certain level of profit sharing, management involvement and decision making. You must determine what you are prepared to relinquish and at what level. Potential investors often require some level of involvement.

Exit Strategy

There must be a plan for the investor to exit. High-risk investors, at some point, want to gain from their investment. The nature, timing and liquidity of this exit plan must be consistent with your perspective.

Shareholder's Agreement

In raising equity, it's wise to establish a shareholders' agreement to define your roles and any restrictions. It will also help to avoid any future misunderstanding.

Legal and Legislative Issues
Mandatory requirements. Assess whether there are any legal or legislative restrictions that make you and a potential investor incompatible. See in the Appendix our Legal and Regulatory Overview Tool for more information.

Take a Closer Look

Some Examples of Contractual Constraints

Debt Covenants
You may have an existing loan agreement that stipulates a certain debt/equity ratio, e.g., not to exceed 1:1. If you are considering raising more debt, will you remain within this financial ratio constraint?

Shareholders Agreements
These agreements may include dos and don'ts. For example, you might not be allowed to raise additional equity investment without the consensus of all the shareholders.

Other Pre-Existing Deals and Commitments
In a strategic alliance with a corporation, for example, the corporation may restrict you from dealing with any of its competitors.

Other Constraints

Non-Contractual Constraints
For example, physical location may preclude certain sources of financing. Another constraint may be timing. If you need the money today, equity might not be a viable option because it takes longer to access.

Shareholders' Control and Partnership Issues
Perhaps you want to maintain voting control (i.e. 51%). While this may rule out equity as an option, generally, it does not, because most investors only want a minority interest. They want you to run the company.

Family or Succession Issues
An equity investor might want one of your relatives out of the company because the investor has a better candidate. Perhaps you plan for your children to take over the business. An equity investor may not agree to this.

Lifestyle Requirements
Will an equity investor cut out certain "perks" like those golf games on Fridays?

2.8 Action Items

To grow, you'll have to craft a financing solution that meets your needs as well as your investors' needs. Investors are looking to balance risk and reward. You will be looking for the right mixture of short-term and long-term obligations, and of equity and debt financing.

You've got to be creative. Look at traditional sources such as banks, internal sources such as your own accounts receivables, and, of course, external risk capital.

The right solution may be a package of financing from different sources, including:

Risk Capital Long-term Financing
- Equity
- Subordinated Debt

Conventional Long-Term Financing
- Term Loans
- Leasing
- Mortgages

Risk Capital Short-Term Financing
- Asset-Based Lending
- Factoring

Conventional Short-Term Financing
- Bank Line of Credit
- Supplier Credit

The following checklist will help you to:

- assess your understanding of the ideas covered in this Step;
- gauge your progress; and
- plan your company's approach.

Checklist

	Status?	Target Date?	Responsibility?
Prepare your financing needs and financial projections so you can use them as a basis for discussion with possible investors.			
Meet with your bank and other conventional sources of financing to determine how much funding you can expect from them.			
Consult with an investment advisor and legal counsel on funding options available to you.			
Investigate if your company is eligible for government assistance through tax credits on research and development, or other sources.			
Consider your funding from a contractual and operational point of view.			
How much should be funded: • internally? • through conventional external sources? • through risk financing?			
How much should be funded with: • debt? • equity?			
Consider the pros and cons of: • equity participation; and • subordinated debt investment.			

Appendix

Take a Closer Look – Four Types of Financing (see section 2.3)

Risk Capital Long-term Financing
Investor Preferences
Long-term risk investors have certain preferences about the companies they want to back. These preferences are usually based on the type, history and status of the company; and the amount of financing needed. These investors prefer dealing with companies whose products are already selling and are proven successes but which lack the capital to exploit their markets. Generally, these investors have excellent contacts in the credit markets and a highly refined sense of how to structure a deal.

Equity
Equity is the interest shareholders hold or own in your company. It's the amount available to shareholders after you've paid all creditors and lenders. This form of financing can be very beneficial to a growing company because there is typically little ongoing cash cost. Often, the exit strategy for investors involves selling their stake to the market at no cost (other than opportunity cost) to the company.

Equity Ownership: Two Basic Types
Preferred Shares. This is long-term to permanent equity that pays a fixed dividend. Shareholders probably don't have voting rights in the company. In the event of liquidation or bankruptcy, preferred shares rank in front of common shares.

Common Shares. This is permanent equity with no dividend commitment. Shareholders have voting rights. In the event of liquidation or bankruptcy, common shares rank last. Equity represents the ultimate business risk. Therefore, it demands the greatest return. Risk capital private equity sources (founders, angels, private venture capital firms, institutional investors, labour-sponsored funds, and government corporations) typically seek returns ranging from 25% to 40% per year.

The required return on equity is relative to the percentage ownership of shares. It is not simply a proportionate share of annual profit and accumulated retained earnings. More accurately, it relates to the present value of future cash flows.

What Equity Will Finance
Initially, there must be sufficient equity capital to start up a company and its operations. But equity financing can also finance:

- growth (current assets and capital asset requirements);
- plant and equipment expansion;
- introduction of new product lines;
- research and development;
- bridge financing before going public;
- acquisitions/management and leveraged buyouts (MBOs and LBOs); and
- restructuring/refinancing.

Sources of Equity
Sources of equity financing include government programs (i.e. contributions); strategic alliances with corporate strategic investors; and guarantees provided by owners, government or other third parties. (Essentially, a guarantee provided to enhance the credit-worthiness of a financing instrument is a potential equity contribution.)

Subordinated Debt
Subordinated debt is a risk capital term debt. Subordinated debt investors accept a higher level of risk, compared with conventional funding sources. Other names for subordinated debt include participating debt, junior debt, mezzanine debt and quasi-equity.

Subordinated debt financing levies about an 8% to 12% rate of interest. But the overall rate of return to the investor will be higher. Participation features enhance the rate of return, and the expected return ranges between 15% and 25% per year. Effectively, investors structure subordinated debt to share in the expected success of the company.

Some examples include:

- royalties (percentage of net cash flow generated from operation);
- participation fees;
- normal cost of common shares;
- warrants or options to purchase shares; and
- rights to convert debt into common shares.

Who or What It's For
Subordinated debt financing is a good option to explore if you have exhausted secured financing (i.e. term loans based on capital assets, or short-term financing based on current assets, are not available). It is better suited to:

- rapidly growing companies;
- expansion programs;
- management and leverage buyouts; and
- acquisitions.

Tailored Instalments
Subordinated debt instalments can be tailored to the characteristics of an individual transaction. Therefore, the risk of borrower default is less compared to conventional long-term sources of financing. For example, subordinated debt may accommodate:

- a subordinated position to a term lender;
- low cash interest commitments; and
- principal payments in a lump sum (e.g. 10 years down the road) tied to performance or waived entirely if the debt is converted to equity.

Sources of Subordinated Debt
Sources of subordinated debt include private sector venture capital firms, institutional investors, labour-sponsored funds and government corporations.

Other Characteristics
Other typical characteristics of subordinated debt may include:

- interest coupons of 8% to 12%;
- terms of five to seven years;
- amounts of $250,000 to $10 million; and
- security subordinated to senior lenders.

(Source: *The Canadian Business Financing Handbook*.)

Conventional Long-Term Financing

Capital assets or fixed assets are often bought through intermediate and long-term financing. Straightforward term loans, usually secured by the capital asset itself, are one example. Equipment vendors and leasing companies also provide financing through leasing arrangements. Lending institutions such as life insurance companies, commercial finance companies, pension funds, and federal and provincial government agencies provide longer financing on capital assets.

Term Loans
Term loans are the principal form of medium-term financing. Although most term loans run from three to seven years, some may last as long as 15 years. With a term loan the borrower agrees to make a series of interest and principal payments on specific dates to a lender. This differs from a bank line of credit where repayment occurs at any time (demand) or at a specified time in one lump sum.

Typical lenders include banks, trust companies, insurance companies, pension funds and the Business Development Bank of Canada.

Maturity
The maturity profile will depend on the lender, the life of the asset being financed, and the borrower's capacity to repay the loan.
Insurance companies and pension funds prefer longer periods of maturity. A commercial bank's time frame tends to be five to seven years. Repayment could be based on equal instalments at regular intervals. You may choose to tailor your repayment instalments to suit a particular situation. Longer terms make this type of financing riskier than bank lines of credit, so banks will typically charge higher interest charges.

Types of Security
Types of security for term loans include specific charge over fixed assets, floating charge over all assets, mortgage over real property, debentures and mortgage bonds.

Leasing
Many businesses lease assets as an alternative to owning them. Leasing is similar to borrowing money to buy assets. In either case, the business uses the asset and either pays off a loan or meets a monthly lease payment. The major difference with a lease, of course, is that the business doesn't own the asset.

There are three types of lease arrangements.

Direct leasing. The business acquires the use of an asset for an agreed-upon series of cash payments.

Sale and leaseback. The business sells an asset (such as a building or equipment) that it already owns and then leases it back. This way, the business receives not only an inflow of cash on the sale of the asset but also the use of the asset.

Capital leases. A third party enters the lessee-lessor arrangement to become the lender who helps finance the acquisition of the asset to be leased. Under this arrangement, payments of principal and interest are made at equal intervals in equal amounts. In many cases, the lessor retains ownership of the leased asset at the end of the lease.

Mortgages
Generally, mortgages are used to finance real property such as land and buildings. Mortgages are long-term financing arrangements (e.g. 25 years). The amount of the mortgage is calculated based on the market value of the property. For example, 75% of the market value might be a common assessment, but you can find mortgage companies, insurance companies and pension funds that will finance up to 90% of the value of the asset. These investors often prefer long maturity periods. They usually base repayment on equal blended payments of interest and principal. Interest rates are fixed for specific terms and depend on the going market rate, the length of the term and availability.

Risk Capital Short-Term Financing

Asset-Based Lending
Asset-based lending is one form of risk capital short-term financing. Just like a bank line of credit, an asset-based loan will be subject to a ceiling amount based on receivable and inventory margins. It also involves a security pledge of accounts receivable and inventories. Pure asset-based loans differ from other loans in that they rely on collateral coverage rather than being linked directly to financial forecasts. Therefore, business and financial risk are less of an issue with asset-based lenders compared to conventional short-term lenders. However, pricing is higher, and interest may range from the prime rate plus 2% to 5% a year.

Factoring
Under factoring, the business makes an outright sale of its accounts receivable to a finance company. The customer is told that the invoice has been sold and is asked to make payments directly to the finance company. This arrangement clearly increases the lender's risk. To reduce the risk, the finance company virtually takes over the work of the borrower's credit department. All orders received from customers are sent to the finance company, which does a credit appraisal. Factoring is fairly costly.

Factoring involves a continuing agreement under which a financing company, the factor, purchases receivables as they occur. The factor assumes the risk of accounts becoming uncollectable and is responsible for collections. The factor may also perform credit checks on customers. There are two types of factoring.

Maturity Factoring
You and the factor agree on an average collection period (e.g. 30 days). Regardless of whether your customer has paid the account at 30 days, the factor will pay you. For example, at the end of 30 days, your customer pays $500 of $1,000 owed. The factor will pay you $1,000 less a commission (typically, 0.5% to 1.5% of the total face amount). The factor may charge you interest on the outstanding portion of the invoice.

Old-Line Factoring
The factor will perform a lending function and advance money to your company based on 70% to 90% of the value of an invoice. The factor may charge interest at prime rate plus 1% to 1.5% per annum, as long as the invoice is outstanding. In this case, you receive cash almost immediately after you make a sale. Depending on the agreement, some factors will have recourse against your company (in the event of bad debts). Other debtors will have no recourse.

Conventional Short-Term Financing

Secured and Unsecured Loans
Loans can be secured or unsecured. A secured loan is backed by collateral that would be applied to recover the loan in case of default. An unsecured loan is not backed by any collateral. These loans are almost always short-term and available only to the most credit-worthy individuals and companies. The loan is backed by your banker's faith in your character, ability to repay the loan and capital (favourable financial structure).

Here are some of the features associated with this type of conventional financing.

Ceiling
Typically, total borrowing may not exceed the lesser of:

- the sum of 75% of accounts receivable, 50% of inventories and 100% of marketable securities (these margins are indicative only); or
- some predetermined dollar amount.

Terms
On demand or committed for a period of less than one year (where demand means the bank can demand repayment at any time, provided it gives "reasonable" time for repayment).

Costs
Costs include:

- prime plus a margin (depending on the risk of your particular situation);
- commitment fee (perhaps one half to three quarters of 1% per year on total committed amount);
- legal costs; and
- monthly administration fees.

Security

- Specific charges over accounts receivable and inventories;
- floating charges over all other assets, except real property;
- documentation (commonly involves a general security agreement at a minimum); and
- a promissory note to show each borrowing under the facility.

Bank Line of Credit

This type of financing is also called operating loans or working capital loans. Short-term debt is for short-term needs: seasonal inventory loans, short-run production or construction loans, and short-term liquidity problems.

Total borrowing usually fluctuates, often daily, to cover expected cash shortfalls. A bank line of credit is a revolving (fluctuating) credit instrument designed to finance fluctuating current assets. It has a stipulated ceiling on total borrowing. A bank line of credit works much like a credit card: you arrange before the need arises to have so much credit to draw against, then you pay it off (or renew it).

The main thing to avoid is routinely using new debt to pay for last year's short-term needs bad enough for an individual, but worse for a small business. Generally, a pledge of current assets (accounts receivable, inventories and marketable securities) supports the business.

A bank may be willing to lend against your current assets provided they are of good quality. It will assess your accounts receivable with regard to age, collectibility and diversification. The bank also assesses your inventory in terms of turnover and obsolescence and your marketable securities with respect to liquidation and market value.

Supplier Credit

Supplier credit is also known as trade financing. Almost all businesses use trade credit. Companies don't pay for their supplies on a cash-and-carry basis. Invoices for materials, supplies and services provided by outsiders are not received until some days after the materials are delivered or the services performed.

Suppliers provide time to pay for orders (e.g. 30 or 60 days). Even better, they may offer cash discounts. A cash discount stated as "2/10, net 30" means you will get a 2% discount if you pay within 10 days; in any event, you to pay within 30 days.

As your company grows, supplier credit also grows. Your volume orders will increase, resulting in increased credit. If, for example, your supplier allows 30 days, you can always try to negotiate better terms. Also, examine whether you are fully using your trade credit. Stretching your accounts payable to their maximum provides a one-time source of additional capital.

Borrow to Take Advantage of Cash Discounts
If suppliers provide a cash discount, you should take advantage of it, even if you have to borrow under your bank line of credit. Consider the following example. Your suppliers provide credit terms of 2/10, net 30. This results in either:

- **Option A**, where the total cost at 30 days is much higher; or
- **Option B**, where the total cost of paying at 10 days and borrowing the amount of the payment from the bank for the remaining 20 days is less.

Suppose that you buy $1,000 worth of supplies and have the option to pay in 30 days or to take advantage of your supplier's credit terms of 2/10, net 30. Here is how the calculation is made. As you can see, borrowing from the bank to pay in 10 days gives a definite economic advantage.

	Option A	**Option B**
Pay supplier		
@ 10 days		$980.00 (98% of $1,000)
@ 30 days	$1,000.00	
Borrow:		
@ 10 days		($980.00)
Pay bank:		
@ 30 days		$980.00
Interest @ 10% per annum		$ 5.37 ($980 X 20/365x.10)
Total cost	$1,000.00	$ 985.37

Tool – Legal and Regulatory Overview (see section 2.7)

Overview of Prospectus-Exempt Financings: A Legal Perspective*

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**The issues addressed in this paper are complex and fact specific, and may vary in application from jurisdiction to jurisdiction. This paper is intended to provide only an overview of the concepts introduced here, and does not offer professional advice for any particular situation, nor does it address the issues completely or address all legal issues which may be related to the matters described here. The reader is urged to consult with an advisor who is knowledgeable in the area of the legal implications of conducting financings and, moreover, is familiar with the requirements of the specific provincial jurisdictions which apply to the offering.*

Introduction and Overview

There are three fundamental principles of securities legislation: the efficiency of capital markets, the integrity of capital markets and investor protection. These principles are very much interrelated in that the integrity and efficiency of the capital markets are fostered, if not maintained, when investors are entitled to rely upon adequate and appropriate safeguards in making their investment decisions. The method and extent of these safeguards vary somewhat, depending upon the route taken by an issuer in gaining access to the capital markets. Under no circumstances, however, does the maxim "let the buyer beware" have any application. The questions, rather, are what is the appropriate gaining in the circumstances of the particular offering, and how to balance an investor's ideal wish for a guaranteed winner and the issuer's desire to raise capital without being exposed to liability in the event things do not turn out as hoped.

Securities legislation in Canada essentially provides three ways of distributing securities:

- pursuant to a prospectus which is filed with, and cleared by, the securities regulatory authority (typically a securities commission) in the relevant jurisdiction;
- by relying upon one or more statutory exemptions from the prospectus requirement (generically referred to as "private placements") in circumstances where the disclosure document, if any, is not required to be reviewed by the securities regulators (but is required to be filed); or
- by obtaining exemptive relief from the relevant securities regulator.

Securities regulation in Canada is a matter of provincial jurisdiction and, accordingly, each province of Canada has its own legislation regulating securities-related matters. Nevertheless, many of the principles and substantive provisions of the legislation in the various provinces are similar in approach.

The Concept of Trading or Distributing Securities

A "trade" in securities is defined broadly and includes any sale or disposition of securities for valuable consideration—but does not include a purchase of securities. In this way, the applicable securities legislation regulates the vendor of securities, but does not regulate the purchaser of securities. Trade is also defined to include any act, advertisement, solicitation, conduct or negotiation directly or indirectly in connection with a sale of a security. For the purposes of the applicable securities legislation, "distribution," where used in relation to trading in securities, includes a trade in securities of an issuer by that issuer (e.g., from treasury).

Commonly Used Exemptions from Prospectus Requirements

In describing a distribution of securities effected pursuant to a prospectus exemption, the term "private placement" is often used. While these different types of offerings are frequently referred to, collectively and generically, as private placements, the different prospectus exemptions result in different practical implications.

The policy behind certain exemptions from the prospectus requirements being permitted is that in certain situations investor protection does not require the detailed disclosure of the proposed investment or it's prior review by the securities regulators. This is frequently because the sophistication of the investor (or the "deemed" sophistication of the investor arising from the size of the investment) suggests that the investor does not "need to know" the information which would ordinarily be contained in a prospectus (i.e., that such an investor is in a position to dictate what protections are appropriate to, or necessary for, that particular person).

The use of certain prospectus exemptions can be beneficial for a number of reasons. First, the delay and the costs inherent in preparing a prospectus can often be prohibitive. Second, in certain circumstances a disclosure document may not need to be prepared. Third, even if such a document is required, the information to be provided in an offering memorandum is generally left to the discretion of the issuer and its counsel, provided that anything included or omitted does not amount to a "misrepresentation." Nevertheless, in some jurisdictions reliance upon certain prospectus exemptions necessitates the preparation of an offering document containing prescribed information.

Statutory exemptions are essentially self-policing, and each element must be reviewed to be satisfied that the issuer is entitled to rely upon a particular exemption. Since many exemptions are based upon the type of investor or facts which relate to the investor, part of this review typically includes obtaining statutory declarations or representations and warranties from the investor as to such facts. Issuers should not, however, blindly rely solely upon such declarations and representations (particularly if the circumstances of the situation suggest that the issuer knows or ought to know that they are likely to be incorrect), but should make reasonable enquiries and investigations to ensure that this reliance is appropriate.

Private Company Exemption

For very early stage financings where the promoter is relying exclusively on family, close friends and pre-existing business associates, one frequently relies upon the prospectus exemption under the applicable securities legislation which exists when one is issuing securities of a "private company" to persons who are not considered to be members of the "public" for the purposes of securities legislation. A "private company," which is defined more specifically in the particular province's securities legislation, is generally considered to be one which has, in its articles of incorporation restrictions on the transferability of its securities, a provision limiting the number of security holders to not more than 50 (not including employees and certain former employees) and a prohibition against inviting the publicto subscribe for its securities. There is generally no definition in the legislation as to which investors are considered to be members of the public for these purposes, and the courts and securities commissions have developed an extensive body of case law and precedent addressing the issue. A number of factors will be considered in making the determination, including the number of persons to whom the issuer tried to sell securities, the number of ultimate purchasers, the sophistication or investment expertise of the purchasers or their access to advice (including their capability to evaluate the merits and risks of the prospective investment), the net worth or ability of the purchasers to risk a complete loss of their investment, the relationship of the purchasers to the vendor, the manner in which the offering is made, the purpose of the offering and the circumstances relating to the vendor. In many cases, the courts and securities commissions have applied the "need to know" rule, whereby they consider a person not to be a member of the public if he or she does not need the type of knowledge about the issuer and the security ordinarily available in a prospectus. No one of the foregoing considerations will be determinative but, rather, the overall circumstance will be evaluated. The determination of who is or is not a member of the public is plagued with uncertainty, and the ultimate determination will be based upon a review of the salient facts—which determination and examination will always be viewed in hindsight often having regard to the views of the judge or the regulators as to whether protection should be extended to the investor.

If an investor is considered to be a member of the public (and, therefore, entitled to the more detailed protections of securities legislation), the trade to such person must be conducted in a manner which allows it to be exempt from the general prospectus requirements of the applicable securities legislation.

Seed Capital Exemption

The "seed capital exemption" is generally used in the relatively early stage of financing of companies in circumstances where the private company exemption is considered to be unavailable (because, for example, the offering is being made to members of the public). The applicable securities legislation should be reviewed to determine the specific eligibility criteria, including whether there is a minimum subscription required (which, for example, under a specific exemption in the British Columbia legislation, requires a minimum subscription of $25,000), whether a specified form of offering document must be prepared, the number of persons to whom an offer may be made, the sophistication requirement of the purchasers, the number of persons who may purchase in reliance upon the exemption and the period of time during which the offering may be made. For example, in Ontario some of the conditions imposed under that province’s securities legislation are that:

- solicitations may be made to not more than 50 prospective purchasers and result in sales to not more than 25 actual purchasers, each of whom must purchase as principal (such numbers being in respect of solicitations and sales in all jurisdictions, including Ontario); and
- each purchaser must have "access to substantially all the same information concerning the issuer that a prospectus" filed under that province's securities legislation would provide and must either be:
- an investor who, by virtue of net worth and investment experience or by virtue of consultation with, or advice from, a person who is not a promoter of the issuer and who is a registered advisor or a registered dealer, is able to evaluate the prospective investment on the basis of information respecting the investment presented by the issuer; or
- a senior officer or director of the issuer, or the parent, brother, sister, child or spouse (common-law or otherwise) of a senior officer or director.

Clearly, the policy behind the seed capital exemption is that an investor who is sophisticated, as evidenced by net worth, business experience, independent advice or close personal bonds of association with the issuer, is deemed to be capable of protecting his/her own interests and, by implication, is not in need of the same kind of investor protection as other investors.

Minimum Subscription Private Placement Exemption

The private placement exemption which is frequently referred to specifically as a "private placement" is based upon a minimum amount of the securities purchased by the investor which, depending upon the particular jurisdiction, varies from $97,000 to $150,000. Since it may be relied upon any number of times without a specific need for the investor to be provided with, or even have access to, any documentation or information, it is one of the most popular exemptions available. Under the applicable securities legislation, the only qualification of the exemption that generally applies is that the purchaser must purchase, as principal, securities having an aggregate acquisition cost of at least the specified amount. Certain securities commissions are of the view that neither corporations or syndicates, nor partnerships or other forms of unincorporated organizations should be created solely to permit purchases by groups of individuals whose individual share of the aggregate acquisition cost is less than the specified amount.

Disclosure Considerations: Documents and Concerns

Exempt Offerings: Offering Memoranda

There are no requirements governing disclosure documents for use in connection with securities issued in reliance upon the private company prospectus exemptions. Moreover, no filings must be made with applicable securities regulators in respect of such financings.

Written material delivered to investors in connection with the seed capital exemption and the minimum subscription private placement exemption will frequently constitute an "offering memorandum" for the purposes of the applicable securities legislation. Business practice often dictates that comprehensive material be prepared for delivery to prospective investors to induce them to acquire offered securities. Each province's securities legislation should be reviewed to determine what the specific requirements within that province are as to the need to prepare an offering document and what, if any, are the required contents of such a document. Moreover, the specific legislation should be reviewed to determine what, if any filings must be made with, and fees paid to, the applicable securities regulator as a result of the financing.

For the purposes of the Ontario securities legislation, for example, an offering memorandum is a document which:

- purports to describe the business and affairs of an issuer;
- has been prepared primarily for delivery to and review by prospective investors to assist those investors in making an investment decision; and
- is prepared in connection with a distribution being conducted in reliance on particular statutory prospectus exemptions, including that province's $150,000 private placement exemption and the seed capital exemption.

A document does not need to be identified as an offering memorandum in order to be treated as such for the purposes of the applicable securities legislation. It could be identified as business plan or an investment proposal or otherwise. Technically, each separate document which fits the foregoing definition constitutes an offering memorandum for the purposes of the Ontario legislation (or, at least, all documents taken together will constitute an offering memorandum). Excluded from the definition of offering memorandum are documents setting out current information about an issuer for the benefit of prospective investors "familiar with the issuer through prior investment or business contacts." Also excluded from the definition, in certain cases, are the annual reports, information circulars, prospectuses and other documents the contents of which are prescribed by statute or regulation. These exceptions will not be discussed here.

When a security is distributed in conjunction with an offering memorandum in reliance upon the Ontario $150,000 private placement exemption or the seed capital exemption, it is generally required that the purchase be given a contractual right of action for rescission or damages in respect of any "misrepresentations" contained in the offering memorandum. These rights are to be described in the offering memorandum and generally correspond to those which a purchaser of securities under a prospectus would have. Moreover, in situations where one is relying upon the seed capital exemption in Ontario, the Ontario legislation requires that the investor have access to substantially the same information concerning the issuer that a prospectus filed under the Ontario securities legislation would provide; this is frequently satisfied by including such information in an offering memorandum.

In some jurisdictions outside of Ontario, the legislation prescribes what must be contained in an offering memorandum delivered in reliance upon certain of the prospectus requirements in such legislation. Neither the Ontario securities legislation nor the Ontario Securities Commission prescribes what an offering memorandum should contain. Given the self-policing nature of offerings pursuant to the seed capital exemption and the private placement exemption, such a decision is thought to rest more appropriately with issuers and their advisors.

The prohibition on an offering memorandum containing a "misrepresentation" implies, having regard to the definition, that the offering memorandum cannot:

- contain an untrue statement of a material fact; or
- omit a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

The term "material fact" means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the securities being offered. Accordingly, once a decision is made to deliver an offering memorandum to prospective investors, it cannot contain only selective information. One cannot, for example, merely highlight the positive aspects of the issuer's business or deal only with certain areas of the business.

Clearly a prospectus standard of disclosure is not required in the offering memorandum, and something short of that is acceptable. Nevertheless, it is not unusual to find that the offering memorandum frequently resembles the format and appearance of a prospectus for practical, although not legal, reasons.

While the securities legislation does not provide that an offering memorandum be reviewed by staff at the applicable securities commissions, there is often a requirement that it be delivered to the securities commissions after completion of the offering.

It should be recognized that the legislation does not contemplate delivery of a draft offering memorandum. Each document (or version thereof) delivered to each investor (including various versions of the offering memorandum) constitutes an individual and separate offering memorandum which must include a contractual right of action.

Use of Future-Oriented Financial Information

It is not always necessary or appropriate to include in the offering document future-oriented financial information (FOFI) consisting of forecasts or projections. Nevertheless, the securities regulators have established a FOFI policy with respect to the inclusion of FOFI in certain specified types of offering documents. The FOFI policy is not generally considered to apply where the offering of securities follows the private company exemption.

A "forecast" is essentially FOFI prepared using assumptions which reflect the issuer's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions. A "projection," by comparison, is FOFI prepared using assumptions that reflect the entity's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions, together with one or more hypotheses (i.e., assumptions that assume a set of economic conditions or courses of action that are consistent with the issuer's intended course of action and represent plausible circumstances).

The policy relating to FOFI specifies the manner in which FOFI may be prepared, disclosed, pre-cleared, dated and subsequently compared with actual results, and also addresses the involvement of auditors with such documents. The FOFI policy applies to disclosure documents such as prospectuses and to offering memoranda prepared for use in connection with the seed capital exemption and the private placement exemption, but does not apply to offerings where the minimum acquisition cost under the offering memorandum is at least $500,000.

The requirements of the policy in connection with the preparation of FOFI are implicitly a list of why many issuers may find that they may not effectively rely upon FOFI in connection with their offerings. Among the requirements are the following.

- FOFI shall be in the form of a forecast. Notwithstanding this, projections may be used for issuers engaged in a business with less than 24 months of relevant operating history or in certain other limited circumstances. A forecast or a projection may be used, but not both.
- The period covered by the FOFI shall not extend beyond the time for which such information can be reasonably estimated (normally the end of the next year i.e., a maximum of 24 months).
- FOFI prepared in accordance with the FOFI policy must be prepared in accordance with the CICA Handbook together with any additional requirements in the policy.
- The need to pre-clear FOFI with the securities commissions in a province prior to filing a preliminary prospectus varies from province to province. Frequently, the requirement to pre-clear before the preliminary prospectus is filed only exists in connection with an initial public offering or in circumstances where an issuer is conducting its first public offering in the particular province. Otherwise, the FOFI is reviewed after the preliminary prospectus is filed and during the normal review process for the remainder of the preliminary prospectus.
- FOFI must be accompanied by an auditor's report, which shall not contain any reservations of opinion.
- The FOFI policy provides that FOFI (other than FOFI in an offering memorandum) shall be reviewed each time the issuer is required to file historical financial statements with the securities commission under its continuous disclosure requirements (i.e., both quarterly and annually) to identify material changes resulting from events that have occurred since it was issued. The FOFI policy also deals with updating the FOFI when a change occurs in the events or in the assumptions used to prepare FOFI that has a material effect on such FOFI. The securities regulatory authorities must approve of the withdrawal of FOFI when it is not being replaced by updated FOFI.

Most companies do not necessarily have expectations that their financial results will be particularly impressive within the 24-month period which is generally the outside date for the FOFI. As a result, the use of FOFI is not generally practical for use by such issuers.

Statutory Liabilities

Criminal Liability

The Criminal Code of Canada provides that every one who, "by deceit, falsehood or other fraudulent means," defrauds the public or any person, whether ascertained or not, of any property, money or valuable security is guilty of an indictable offence and on conviction is liable to imprisonment for 10 years where the value of the subject matter of the fraud exceeds $1,000 and lesser penalties where the value is under $1,000. The Criminal Code of Canada specifically provides that every one who, "by deceit, falsehood or other fraudulent means," affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public, is guilty of an indictable offence and, on conviction, is liable to imprisonment for a term not exceeding 10 years.

Quasi-Criminal Liability

The securities legislation of certain of the Canadian provinces provides that a director or officer who "authorized, permitted or acquiesced in" certain activities, including a breach by an issuer under the legislation (such as the issuance of securities without the preparation of a prospectus in circumstances where a prospectus exemption was not available), commits an offence and, on conviction, is liable to a fine and imprisonment. In Ontario, for example, the fine is up to $1,000,000 and the imprisonment is up to two years, or both.

Conclusion

At some stage in a company's development, it will likely be necessary for the founders to seek additional funding for the company's operations by attempting to get access to the capital markets. Securities regulation generally presumes that an offering of securities by an issuer must be made pursuant to a prospectus unless an exemption from the prospectus requirement is available. This paper has outlined some of the considerations for an issuer pursuant to an offering by way of private placement. The method by which the issuer gains access to the capital markets and the types of prospectus exemptions which are relied upon will have a dramatic impact upon the requirements which are imposed upon (and the issues which should be addressed by) the issuer and its senior officers and directors before and during the offering, as well as on an ongoing basis.