



Science & Engineering Business Association

Business Basics: Accounting

Introductions

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Agenda

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Funding: Types

- ▶ Debt

- ▶ Receive cash and repay the principal plus interest in the future

- ▶ Equity

- ▶ Receive cash and give up a percentage ownership in the entity

Funding: Comparison of Types

	Debt	Equity
Investor protection	Protective <u>debt covenants</u> ; audited financial statements typically required	Board representation and participation in major decisions; audited financial statements typically required
<u>Investment horizon</u>	Finite - typically contractually set	Indefinite, but investors do grow impatient and need to see a return within their investment horizon
Investor returns	Repayment of principal plus a stated interest rate	A <u>liquidity event</u> (sale of stock, buyout by another enterprise) may provide huge returns – or huge losses
Unique terms	<u>Warrant</u> coverage Success fees Personal guarantees	<u>Antidilution</u> provisions
Investor risk tolerance	Expect repayment	Expect 80%+ of ventures to fail

Funding: Sources

- ▶ Your own savings
- ▶ Family and friends
- ▶ Banks
- ▶ Angel investors
- ▶ Venture capitalists
- ▶ IPO markets
- ▶ Grants
- ▶ Collaboration partners

Funding: Recent Examples

Source	Example	Industry
Angel investors	Northwest Energy Angel's members invested in Propel, Inc.; other angel groups include Keiretsu Forum, Paladin Partners, and Zino Society	Cleantech 
Venture capitalists	Calypso Medical Technology raised \$50 million through venture capitalists led by Frazier Healthcare Ventures and Skyline Ventures in September 2009	Medical Devices 
Public funding	Omeros raised \$68.2 million through its IPO in October 2009	Pharmaceuticals 
Grants	Geospiza won a \$110,000 Small Business Innovation Research Grant from the National Human Genome Research Institute	Software 

Oversight

Once investors put up capital – they want to oversee their investments. Where this intersects with accounting is through:

- ▶ Board representation
- ▶ Audited financial statements
- ▶ Ratio analysis

Oversight: Board Representation

- ▶ Investors participate as directors on the Board of Directors as a way to monitor their investment and the entity's progress
- ▶ For startup enterprises, they often focus on:
 - ▶ Building a high quality management team
 - ▶ Monitoring and minimizing cash burn
 - ▶ Maximizing runway
 - ▶ Evaluating other financial ratios
- ▶ For more mature enterprises, they switch their focus to:
 - ▶ Maximizing cash generated from operations
 - ▶ Developing an exit strategy

Oversight: Audited Financial Statements

- ▶ When is an audit required?
 - ▶ Private investors generally don't require audits until their investment is significant
 - ▶ Bankers generally do require audits before they make loans
 - ▶ Three years of audits are required for an IPO
 - ▶ Ernst & Young typically works with startups from a state and local tax perspective before we start doing audits as these issues arise sooner
- ▶ The financial statements are management's responsibility
 - ▶ Many startup ventures do not have CFOs – so they get a part-time person or consultant that handles these matters – including financial statement analysis


Oversight: Ratio Analysis

- ▶ Different types:
 - ▶ Liquidity – is the entity able to meet its short term obligations?
 - ▶ Asset turnover – how efficiently does the asset utilize its assets?
 - ▶ Financial leverage – what is the entity’s long-term solvency?
 - ▶ Profitability – how profitable is the entity?

- ▶ Words of caution:
 - ▶ Reference point? Analyze against peers or over time to tell a story.
 - ▶ Use averages for balance sheet information
 - ▶ Only as useful as underlying data

Ratios: Examples from Omeros

Omeros Corporation



**6,820,000 Shares
Common Stock**

This is the initial public offering of Omeros Corporation. We are offering 6,820,000 shares of our common stock. Our common stock will be traded on the NASDAQ Global Market under the symbol "OMER."

Investing in our common stock involves risk. See "Risk Factors" beginning on page 11.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price	\$10.00	\$68,200,000
Underwriting discounts and commissions(1)	\$ 0.70	\$ 4,774,000
Proceeds, before expenses, to Omeros Corporation	\$ 9.30	\$63,426,000

We have granted the underwriters the right to purchase up to 1,023,000 additional shares of common stock to cover over-allotments.

Deutsche Bank Securities

Wedbush PacGrow Life Sciences

Canaccord Adams Inc. Needham & Company, LLC

Chicago Investment Group National Securities

The date of this prospectus is October 7, 2009.

(1) These amounts do not include warrants held by Chicago Investment Group, LLC and selling group members, which may constitute compensation. See "Underwriters."

References:

- ▶ Auditor opinion – F-2
- ▶ Balance sheet:
 - ▶ assets – F-3
 - ▶ liabilities and equity – F-4
- ▶ Statement of operations – F-5
- ▶ Statement of cash flows – F-14

Ratios: Liquidity

- ▶ **Current Ratio** - a measure of the degree to which current assets cover current liabilities ($=\text{Current Assets} / \text{Current Liabilities}$). A high ratio indicates a good probability the enterprise can retire current debts. A ratio of 2.0 or higher is typically a comfortable financial position for most enterprises.
- ▶ **Quick Ratio** - a measure of the amount of liquid assets available to offset current debt ($=\text{Current Assets} - \text{Inventories} / \text{Current Liabilities}$). A healthy enterprise typically keeps this ratio at 1.0 or higher.
- ▶ **Cash Ratio** - a measure of the amount of cash available to offset current debt ($= \text{Cash} + \text{Liquid Investments} / \text{Total Current Liabilities}$). A ratio below .5 may mean you are having cash flow problems, possibly because of a significant backlog in accounts receivable.
- ▶ Note that liquidity concerns can cause auditors to modify their audit opinion with “going concern” language – see page F-2 of the Omeros prospectus

Ratios: Liquidity Examples

Summary financial data (dollars in thousands)

		6/30/2009	12/31/2008	12/31/2007
A	Cash and cash equivalents	\$ 1,283	\$ 12,726	\$ 5,925
B	Short-term investments	\$ 9,080	\$ 7,256	\$ 18,157
C	Inventories*	\$ 250	\$ 250	\$ 250
D	Current assets	\$ 11,116	\$ 20,478	\$ 24,461
E	Current liabilities	\$ 23,217	\$ 23,561	\$ 7,935

Liquidity ratios (note that each is more restrictive)

		6/30/2009	12/31/2008	12/31/2007
D/E	Current ratio	0.48	0.87	3.08
(D-C)/E	Quick ratio	0.47	0.86	3.05
(A+B)/E	Cash ratio	0.45	0.85	3.03

*Note that Omeros Corporation does not have inventories, but amounts were included here to demonstrate the calculation of the quick ratio.

Ratios: Asset Turnover

- ▶ **Receivables Turnover** – how quickly does the entity collect on its receivables? ($=\text{Revenues}/\text{Average Accounts Receivable}$)
- ▶ **Inventory Turnover** – how many times does the entity turn its inventory per year? ($=\text{Cost of Goods Sold}/\text{Average Inventory}$)
- ▶ These ratios relate the statement of operations to the balance sheet and can show:
 - ▶ Is the entity generating a lot of credit sales, but not collecting the cash?
 - ▶ Is the entity accumulating too much inventory related to their sales volume?

Ratios: Asset Turnover Examples

Summary financial data (dollars in thousands)

		6/30/2009**	12/31/2008	12/31/2007
A	Revenues	\$ 568	\$ 1,170	\$ 1,923
B	Cost of goods sold*	\$ 284	\$ 585	\$ 962
C	Receivables, beginning of period	\$ 207	\$ 190	\$ 1,300
D	Receivables, end of period	\$ 570	\$ 207	\$ 190
E	Receivables, average	\$ 389	\$ 199	\$ 745
F	Inventories, beginning of period*	\$ 175	\$ 175	\$ 175
G	Inventories, end of period*	\$ 250	\$ 250	\$ 250
H	Inventories, average*	\$ 213	\$ 213	\$ 213

Turnover ratios

		6/30/2009**	12/31/2008	12/31/2007
A/E	Receivables turnover	2.92	5.89	2.58
B/H	Inventory turnover	2.67	2.75	4.52

*Note that Omeros Corporation does not have inventories, nor cost of goods sold, but amounts were included here to demonstrate the calculation of the inventory turnover ratio.

**Note that the revenues and cost of goods sold data for 6/30/2009 represents six months; accordingly, the amounts were annualized in the calculations.

Ratios: Financial Leverage

- ▶ **Debt ratio** – how much does the entity rely on debt to finance its total assets? ($=\text{Debt}/\text{Total Assets}$)
- ▶ **Debt to equity ratio** – what is the relative portion of financing from debt and equity? ($=\text{Debt}/\text{Equity}$)
- ▶ **Interest coverage** – how easily can the entity pay its interest obligations? ($=\text{Earnings Before Interest and Taxes}/\text{Interest Expense}$)

Ratios: Financial Leverage Examples

Summary financial data (dollars in thousands)

		6/30/2009	12/31/2008	12/31/2007
A	Notes payable	\$ 15,192	\$ 16,674	\$ 1,010
B	Total assets	\$ 12,682	\$ 21,681	\$ 27,162
C	Shareholders equity*	\$ (10,629)	\$ (1,998)	\$ 19,227
D	Earnings before interest and taxes	\$ (10,426)	\$ (23,492)	\$ (22,940)
E	Interest expense	\$ 1,165	\$ 335	\$ 151

Turnover ratios

		6/30/2009	12/31/2008	12/31/2007
A/B	Debt ratio	1.20	0.77	0.04
A/C	Debt to equity ratio	(1.43)	(8.35)	0.05
D/E	Interest coverage ratio	(8.95)	(70.13)	(151.92)

*Includes preferred stock - which is often presented outside of equity

**Note that startup entities typically operate with a loss and therefore do not "cover" their interest expense; hence the negative ratio.



Ratios: Profitability

- ▶ Gross profit margin ($= \text{Gross Profit} / \text{Revenue}$)
- ▶ Operating profit margin ($= \text{Operating Profit} / \text{Revenue}$)
- ▶ Effective income tax rate ($= \text{Provision for Income Taxes} / \text{Pre-Tax Income}$)
- ▶ Net profit margin ($= \text{Net Profit} / \text{Revenue}$)
- ▶ Return on assets ($= \text{Net Profit} / \text{Total Assets}$)
- ▶ Return on equity ($= \text{Net Profit} / \text{Total Equity}$)

- ▶ For startup ventures – it typically takes years to attain profitability; accordingly, these ratios are often not applicable – we'll use The Coca-Cola Company and Pepsico in these example calculations

Ratios: Profitability Examples

Summary financial data (dollars in MILLIONS)

					
		COCA COLA quarter ended 7/3/09	COCA COLA quarter ended 6/27/08	PEPSICO 12 weeks ended 6/13/09	PEPSICO 12 weeks ended 6/14/08
A	Revenue	\$ 8,267	\$ 9,046	\$ 10,592	\$ 10,945
	Cost of goods sold	\$ 2,913	\$ 3,162	\$ 4,881	\$ 5,078
B	Gross profit	\$ 5,354	\$ 5,884	\$ 5,711	\$ 5,867
	Selling, general and administrative	\$ 2,844	\$ 3,095	\$ 3,507	\$ 3,658
	Other operating expenses	\$ 72	\$ 110	\$ 14	\$ 18
C	Operating income	\$ 2,438	\$ 2,679	\$ 2,190	\$ 2,191
	Interest income, interest expense and other	\$ 290	\$ (762)	\$ 46	\$ 132
E	Income before income taxes	\$ 2,728	\$ 1,917	\$ 2,236	\$ 2,323
E	Provision for income taxes	\$ 679	\$ 474	\$ 568	\$ 618
F	Net income	\$ 2,049	\$ 1,443	\$ 1,668	\$ 1,705
G	Assets	\$ 46,054	\$ 47,731	\$ 37,050	\$ 36,779
H	Equity	\$ 23,517	\$ 23,182	\$ 14,409	\$ 16,747
B/A	Gross margin percentage	65%	65%	54%	54%
C/A	Operating margin percentage	29%	30%	21%	20%
E/D	Effective income tax rate	25%	25%	25%	27%
F/A	Net margin percentage	25%	16%	16%	16%
F/G	Return on assets	4%	3%	5%	5%
F/H	Return on equity	9%	6%	12%	10%

Terminology

- ▶ **Antidilution provisions** – protective provisions in equity instruments that prevent dilution to existing investors
- ▶ **Cash burn** – how much cash the entity uses in a specified period – typically one month
- ▶ **Debt covenant** – contractual restrictions typical in debt agreements (may specific minimum ratios, require an audit, or the provision of financial statements 90 days after year-end)
- ▶ **Dilution** – the decrease in ownership or conversion rights suffered by current investors upon the issuance of additional stock by the entity
- ▶ **Due diligence** – the process by which an investor (or group of investors) evaluate a potential investment opportunity
- ▶ **Exit Strategy** – an investor’s strategy for selling their investment to realize a return (e.g. sale, merger, etc.)
- ▶ **Investment horizon** – the amount of time until an investor expects a return on (or of) their investment
- ▶ **Runway** – how many months until the entity uses all of its cash and needs another capital infusion?
- ▶ Other terms you’ve heard that we should discuss?

Questions

