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ADVISORY

# The Dos and Don'ts for Startup CPAs During a Recession

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By Vanessa Kruze, Founder & CEO at Kruze Consulting.

Let's face it: It doesn't look like the economy is going to be returning to normal soon. The COVID pandemic, a war in Ukraine, supply chain disruptions, and increasing inflation (which the Federal Reserve is addressing by raising interest rates), are all combining to suppress economic growth. And while the labor market is currently strong, the Bureau of Economic Analysis (BEA) stated that real gross domestic product (GDP) declined by 1.6 percent in Q1 of 2022. A recession isn't a sure thing, but the warning signs are there.

If you're a CPA working with startups, like we do at Kruze Consulting, your clients are probably looking to you to help them prepare for the worst. Winston Churchill said it best: ""**Never** let a **good crisis** go to **waste**". While these are turbulent times, it's also an opportunity for CPAs to step up and become that de-facto advisor, helping clients navigate unfamiliar territory. If executed well, a CPA can be a hero and forge lifelong bonds with clients. If you have clients that have never experienced a recession, you may need to educate them on what to do and, just as importantly, what not to do. Let's start with what to do.

## DO: Look for ways to extend the runway

Every startup is different, but most aren't generating revenue yet. That means the startup's runway (the number of months it can keep operating without running out of money) is critically important. On average, recessions over the last 160+ years have lasted less than 17.5 months, and that's dropped to less than 11.1 months since World War 2, according to Kiplinger. Startups with longer runways, like two years, don't need to be as concerned as those with six months of funds in the bank. But every startup can benefit from trimming expenses, so we recommend:

- **Audit expenses.** Every company should conduct a line-by-line review of expenses and look for things that can be cut. While most travel and expense items are obvious targets, most businesses' spend is heavily dependent on 3 things: payroll, rent, and contractors. Cutting subscriptions and marginal costs are not material and will not change your budget, so focus on the big buckets. Review your hiring plan and ensure that it's flexible to accommodate for the rapidly changing economy. Corporate leases should be reviewed (rent is one of most startups' largest expenses). With more employees working remotely, rent might be reduced or even eliminated. Review terms and rates with contractors. Remember, a recession could last a year or more. Even if a lease term isn't ending now, the company should

consider eliminating or renegotiating leases that will end in the next 12 months. This is obviously an area where CPAs are uniquely qualified to offer solid advice to businesses.
- **Prepare the CEO to talk to the team.** As part of the expense audit, before making cuts, management should discuss it with the staff. You should encourage your clients to be reasonably open about the company's financial situation and ask for their input on reductions. Often, founders and CEOs find that things considered essential actually aren't.
- **Slow down or freeze hiring.** Payroll is typically a startup's biggest expense. Consider pausing on new hires until the startup is in a better position. Reducing headcount should be a last resort – startups usually run lean, and cutting staff may mean missing milestones. Reducing benefits, pay cuts, and layoffs are all options, but they will all come at a cost in productivity, morale, and reputation. At Kruze, we are seeing startups "re-outsource" – they've hired staff who left, or they are having trouble filling positions, or they need to reduce expenses, so they return to outsourced service providers they previously used. This is another great place where CPAs are qualified to offer advice – if you haven't already, this is the moment to help your clients set up financial models.
- **Look for yield on cash.** One major counterpoint to the Fed raising interest rates is that startups with millions of dollars in the bank account now may be able to get some yield. And that extra cash can help keep a critical hire on the books. CPAs should have relationships with banks and other institutions that can help a startup manage their cash. And accountants can help founders understand how much capital they need liquid and the importance of cash preservation when doing yield-focused cash management.

## DO: Help raise capital

If a startup is gaining traction and you have a strong financial model and solid metrics to show investors or lenders, raising capital may be an option. But things have changed since the frothy valuations of 2020 and 2021, and accountants will probably need to help founders adjust to the current conditions:

- **Due diligence is more important than ever.** VC investors want to see that their money is going to be used wisely, so founders need to be able to show their plans and demonstrate a long-term strategy. Now VC investors want to know that the cash they supply can last a while, to get the startup through a market contraction. For example, investors may ask if the company has enough funding for 36 months, rather than 18 to 24 months. Founders should be ready with projections that cover

a longer timeframe. Also, investors are digging deeper, checking references and conducting evaluations – which means venture capital funding deals are taking longer. Startup clients in these situations will need more detailed information with longer projections. CPAs with startup clients need to be prepared to assist their clients respond to VC due diligence checklists ahead of time. And helping less experienced founders understand how VCs make money can prepare them for the pitch process.

- **Deals may have more structure.** Investor-protective provisions are showing up on more term sheets now. When capital was accessible, VC investors couldn't require protective covenants. Now, VCs are including preferred treatment terms, such as multiple liquidation preference, where investors get double or triple their capital back before other shareholders get paid. Another possible liquidation provision could be that the VC investors receive their investment back plus their percentage ownership in any remaining funds. These downside protection provisions haven't been common in years, so CPAs may need to educate their startup clients about them.
- **Lower valuations are reality.** Startups may simply have to accept a lower valuation to obtain funding. In the first quarter of 2022, only 5 percent of the total venture capital deals were down rounds (where startups sold shares at a lower price per share than previous rounds), according to Pitchbook. However, we're seeing more flat or small valuation increases, so startups may need to pitch investors on flat or extension rounds. CPAs may have to help startup clients accept lower valuations and restructure their pitches to reflect the new environment.

## DO: Encourage transparency

Communicating very clearly with all stakeholders is critically important in a tough economy. Founders need to maintain a regular dialogue with their VC investors, their board of directors, customers (if applicable at this stage), and their employees. All of these groups want your company to succeed, and they can all provide ideas, encouragement, networking opportunities, and even funding options. Founders should update everyone on current plans, critical decisions, and the general strategy, and a startup CPA can provide input into these updates. Founders can also get more information about startup management and the startup ecosystem from Kruze Consulting's videos. We've seen that our clients who are the most proactive in providing communication to their VCs about their cash runway and spending plans are the ones who are most likely to get bridge financing from those investors. CPAs

can help clients prepare the financial figures and charts used in these communications.

## DON'T: Let clients get emotional

When funds get tight, everyone in a startup feels the pressure. And pressure can lead to poor decisions. Startup founders need a logical, data-based plan to weather economic hard times and move to recovery, and accountants provide the data. We encourage our clients to:

- **Show, don't tell.** Using data, company leaders should provide a road map that shows the long-term path to growth and success, and CPAs are essential to assembling that data. This communication is critical to reassure investors, boards, and employees that there is a plan. Instilling confidence is critical, particularly for employees. If expert engineers, developers, and researchers get discouraged and leave, they will be hard to replace.
- **Look for opportunities.** Focus and identify the initiatives needed to grow the startup, and prioritize funding and resources for those investments. Tough markets can weed out competitors, and that's true for startups as well. Layoffs at other companies can provide an opportunity to hire top talent. Similarly, when one startup doesn't have what it takes to survive, that may free up venture capital for stronger startups. CPAs can help startup clients present a stronger case to venture capitalists or venture lenders.
- **Avoid personal guarantees for business loans.** When the economy stumbles, founders may explore loans that require a personal guarantee, making them responsible for any remaining balance if the business defaults. Small business loans often require these guarantees. In general, founders who have raised outside capital should avoid guaranteeing a loan with their personal assets. In the rare cases where the risk may be worth the gamble, startup accountants need to carefully review the potential risks with their clients.
- **Don't be afraid of a down round.** Startups often place too much emphasis on high valuations that they've gotten in the past. However, sometimes a down round makes sense, giving the startup a reset that reflects the reality of current economic conditions. That type of reset can make the next fundraising round much easier, but trying to support an artificially high valuation can cause a startup to make serious mistakes, like increasing burn rates to unsustainable levels. The phrase "dilution never killed a company" applies here – owning a smaller piece of a bigger pie may make sense. A CPA may need to take a founder through the math to show the potential advantages of accepting a down round.

## Take the right steps

It's too soon to know what direction the economy will take. The current downturn may be a short downturn or a more long-term correction. However, every startup can benefit from taking steps to become more efficient, obtain financing, and avoid overreacting. As CPAs, we can help founders make the right moves to adjust to current economic conditions and weather the recession. And startups that adapt to the changing market and investment conditions could emerge even stronger on the other side of a downturn.

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Vanessa Kruze, CPA, is the founder and CEO Kruze Consulting, providing startup CFO consulting, including accounting, tax and HR services, to startups in San Francisco, Los Angeles, and New York City. Prior to establishing her firm in 2012, Vanessa began her career with Deloitte Tax and is a University of San Francisco alumni.

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