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The Funding Round: Term Sheets, Valuation, and the CFO's Role

Pre-money and post-money valuation, the term sheet provisions that matter most financially, liquidation preferences, anti-dilution, pro-rata rights, due diligence, and data room preparation

WHAT YOU WILL LEARN AND WHY IT MATTERS

A venture funding round is simultaneously a financial transaction, a legal negotiation, a commercial relationship, and an organizational milestone. The CFO's role in this process is more central than most founders and executives appreciate: the CFO is responsible for the financial data preparation that underlies the investor's due diligence, the financial modeling that informs the board's evaluation of the proposed terms, the due diligence management that determines the quality and efficiency of the process, and the post-closing financial accounting that properly reflects the terms of the financing in the company's financial statements.

This part covers the financial dimensions of the venture funding round from the CFO's perspective: the valuation mechanics that determine how much of the company the investor receives for their capital, the key term sheet provisions and their financial implications, the due diligence process and the data room discipline required to support it efficiently, and the accounting treatment of the financing that establishes the financial foundation for subsequent reporting.

VALUATION MECHANICS: PRE-MONEY, POST-MONEY, AND THE OPTION POOL

The most financially significant element of any venture funding round is the valuation — the price at which the investor is buying shares in the company, which determines both the investor's ownership percentage and the dilution experienced by existing shareholders. The vocabulary of venture valuation is specific and consequential, and the CFO must be precise about these terms.

PRE-MONEY VALUATION: The pre-money valuation is the value of the company before the new investment is added. It is the price that the investor and the company agree the company is worth today, before the investor's capital is received.

POST-MONEY VALUATION: The post-money valuation is the pre-money valuation plus the new investment amount. It is the implied value of the company after the new investment is received: $\text{post-money} = \text{pre-money} + \text{investment amount}$. The investor's ownership percentage is equal to the investment amount divided by the post-money valuation: if a company raises ten million dollars at a forty million dollar pre-money valuation, the post-money valuation is fifty million dollars and the investor owns twenty percent.

THE OPTION POOL SHUFFLE: One of the most important and frequently misunderstood elements of the venture valuation negotiation is the option pool requirement. Most venture investors require that the company establish or expand an unallocated option pool — typically ten percent to twenty percent of the post-money capitalization — as a condition of the investment. The controversy is in the timing: investors typically require the option pool to be created from pre-money shares rather than post-money shares.

When the option pool is included in the pre-money capitalization, the effective pre-money valuation received by existing shareholders is lower than the stated pre-money valuation. For example: if the pre-money valuation is stated as forty million dollars but ten percent of the post-money shares must be

reserved for the option pool before the investment closes, the effective pre-money valuation received by existing shareholders is significantly less than forty million dollars because the option pool shares dilute the existing shareholders before the investor's capital arrives. The CFO must model this option pool dilution explicitly and present the effective pre-money valuation to the board as part of the term evaluation.

KEY TERM SHEET PROVISIONS: FINANCIAL IMPLICATIONS

A venture term sheet contains dozens of provisions, but a relatively small number of them have the most significant financial implications for the company and its existing shareholders. The CFO must understand each of these provisions and their specific financial impact.

LIQUIDATION PREFERENCES: The liquidation preference is the provision that determines how much money the preferred stockholders (the VC investors) receive before the common stockholders (founders and employees) receive anything in an exit event. Standard liquidation preferences take two forms: non-participating preferred and participating preferred.

Non-participating preferred gives the investor the right to receive either (a) their invested capital back (a one-times liquidation preference) or (b) their pro-rata share of the proceeds as if they had converted to common stock — whichever is greater. In a large exit, the investor will typically convert to common and participate pro-rata; in a small exit, the investor will take their liquidation preference.

Participating preferred — sometimes called "double-dipping" — gives the investor both (a) their invested capital back and (b) their pro-rata share of the remaining proceeds. Participating preferred is significantly more expensive for founders and employees in mid-range exit scenarios. The CFO must model the financial impact of both structures across the full range of exit values to present the board with a clear picture of how the liquidation preference affects founder and employee proceeds in different exit scenarios.

ANTI-DILUTION PROVISIONS: Anti-dilution provisions protect the investor from the financial impact of a "down round" — a subsequent financing at a lower valuation than the investor paid. The two standard forms are broad-based weighted average anti-dilution (the most common and most benign form, which adjusts the conversion price of the preferred stock based on a weighted average of all shares outstanding) and full ratchet anti-dilution (the most aggressive form, which adjusts the conversion price to the price of the down round, effectively giving the investor the full benefit of the lower valuation at the company's and existing shareholders' expense).

PRO-RATA RIGHTS: Pro-rata rights give the investor the right to invest in subsequent financing rounds at the same terms as new investors, in an amount sufficient to maintain the investor's ownership percentage. Pro-rata rights are valuable to investors because they allow them to invest more capital in the companies that are performing best — the power law winners — before other investors dilute their position. For the company, pro-rata rights can be either beneficial (providing access to additional capital from existing investors who know the company well) or limiting (reducing the amount of the next round available to new investors who bring additional strategic value).

INFORMATION RIGHTS AND BOARD COMPOSITION: While not strictly financial provisions, the information rights and board composition provisions of the term sheet have direct financial governance implications. Information rights — the investor's right to receive regular financial reports, the right to inspect the company's books and records, and the right to receive advance notice of significant transactions — define the financial reporting obligations the CFO must meet. Board composition — the number and allocation of board seats between investor-designated directors and founder-designated directors — determines the governance structure within which the CFO's financial recommendations are evaluated.

FINANCIAL DUE DILIGENCE: WHAT INVESTORS ACTUALLY CHECK

The investor's financial due diligence process — the analytical review of the company's financial position, financial history, and financial projections that precedes the final investment decision — is one of the most important financial management processes the CFO will manage. The quality of the due diligence materials, the accuracy of the financial data, and the efficiency of the due diligence process all directly affect the investor's confidence in the company's financial management capability and indirectly affect the final terms of the investment.

FINANCIAL STATEMENT REVIEW: The investor's due diligence typically begins with a review of the company's historical financial statements. For early-stage companies, these may be unaudited management accounts; for later-stage companies, the investor will expect audited financial statements for the most recent one to three fiscal years. The CFO must ensure that the historical financial statements are accurate, consistently prepared, and fully reconciled to the underlying accounting records. Common due diligence findings that create problems include inconsistencies between the financial statements and the underlying records, revenue recognition practices that are aggressive or inconsistent, and expense classifications that don't follow GAAP conventions.

UNIT ECONOMICS VERIFICATION: For venture-backed companies, the most analytically intensive element of the financial due diligence is the unit economics verification. The investor will attempt to independently verify the key unit economics metrics that the company has presented: customer acquisition cost (CAC), customer lifetime value (LTV), the LTV/CAC ratio, and the payback period. The CFO must ensure that these metrics are calculated consistently with the definitions the investor uses and that the underlying data — the cohort data showing how customer acquisition costs and customer revenues have evolved over time — is available in the data room and accurately supports the reported metrics.

FINANCIAL MODEL REVIEW: The investor will review the company's financial model — the forward-looking financial projections that underlie the company's strategic plan and the valuation negotiation. The CFO must be prepared to defend every assumption in the financial model: the revenue growth rate assumptions, the gross margin trajectory, the operating cost structure, the headcount plan, and the capital expenditure requirements. The financial model review is as much an assessment of the CFO's analytical capability and intellectual honesty as it is a review of the numbers — the investor is

evaluating whether the CFO's financial modeling reflects rigorous analysis or optimistic assumption-making.

DATA ROOM ARCHITECTURE AND DUE DILIGENCE MANAGEMENT

The data room — the organized repository of documents and information that the investor reviews during due diligence — is one of the CFO's primary deliverables in a fundraising process. A well-organized, complete, and accurate data room accelerates the due diligence process, reduces the number of follow-up information requests, and creates a professional impression of the company's financial management capability. A poorly organized, incomplete, or inaccurate data room creates delays, generates anxiety in the investor about the company's financial management, and can derail a financing round that would otherwise have closed successfully.

THE DATA ROOM STRUCTURE: The financial section of the data room should be organized around five categories. Historical financials: audited (or reviewed) financial statements for all available periods, with clear labeling of which periods have been audited and by which firm. Management accounts: monthly financial statements for the current and prior fiscal year, showing the detailed income statement, balance sheet, and cash flow statement. Financial model: the company's forward-looking financial projections in a format that allows the investor to test assumptions, including the key business drivers that underlie the revenue projections. KPI data: the historical data underlying the company's key performance indicators, in a format that allows the investor to independently verify the metrics reported in the pitch materials. Cap table: the current capitalization table, showing all outstanding shares by class and holder, all outstanding options and warrants, and the waterfall analysis showing how proceeds would be distributed across the cap structure at various exit values.

THE DUE DILIGENCE TRACKER: The CFO should maintain a due diligence tracker — a document that lists every information request received from the investor, the status of the company's response, the responsible person, and the target completion date. This tracker serves two purposes: it ensures that no information request falls through the cracks, and it demonstrates to the investor that the company's management team is organized and responsive — a quality signal that positively affects the investor's overall assessment of the management team.

ACTIONS TO TAKE BEFORE PART FOUR

Prepare the financial due diligence package for the next anticipated financing round, even if the round is not yet being actively pursued. The package should include clean historical financial statements, a well-documented financial model, a verified KPI dataset, and a current cap table with waterfall analysis. Having this package ready before the fundraising process begins reduces the time pressure of the due diligence process and allows the CFO to focus on responding to investor-specific questions rather than assembling basic financial documentation under time pressure.

Model the financial impact of the standard term sheet provisions — participating versus non-participating liquidation preference, broad-based versus full ratchet anti-dilution, and option pool size — across the full range of expected exit values. This analysis provides the board with a clear picture of how different term structures affect the financial outcomes for founders, employees, and investors across different exit scenarios, enabling an informed negotiation rather than an intuition-based reaction to the investor's proposed terms.

CLOSING PERSPECTIVE

The funding round is where the company's financial governance is scrutinized most intensively and where the terms that will govern the relationship with the investor for the next several years are established. The CFO who prepares for this process with analytical rigor — who has clean financial statements, a well-documented financial model, a thorough data room, and a clear-eyed analysis of the term sheet's financial implications — is providing the financial leadership that makes the best available financing terms achievable and the investor relationship off to the strongest possible start.

COMING NEXT IN THE SERIES

Part 4 — The Cap Table: Building, Managing, and Modeling Equity Ownership

Part Four covers the capitalization table as the CFO's primary equity governance tool — how to build and maintain a clean cap table from the earliest stages, the dilution modeling that every financing round requires, option pool management, waterfall analysis, and the cap table modeling that supports exit scenario analysis.