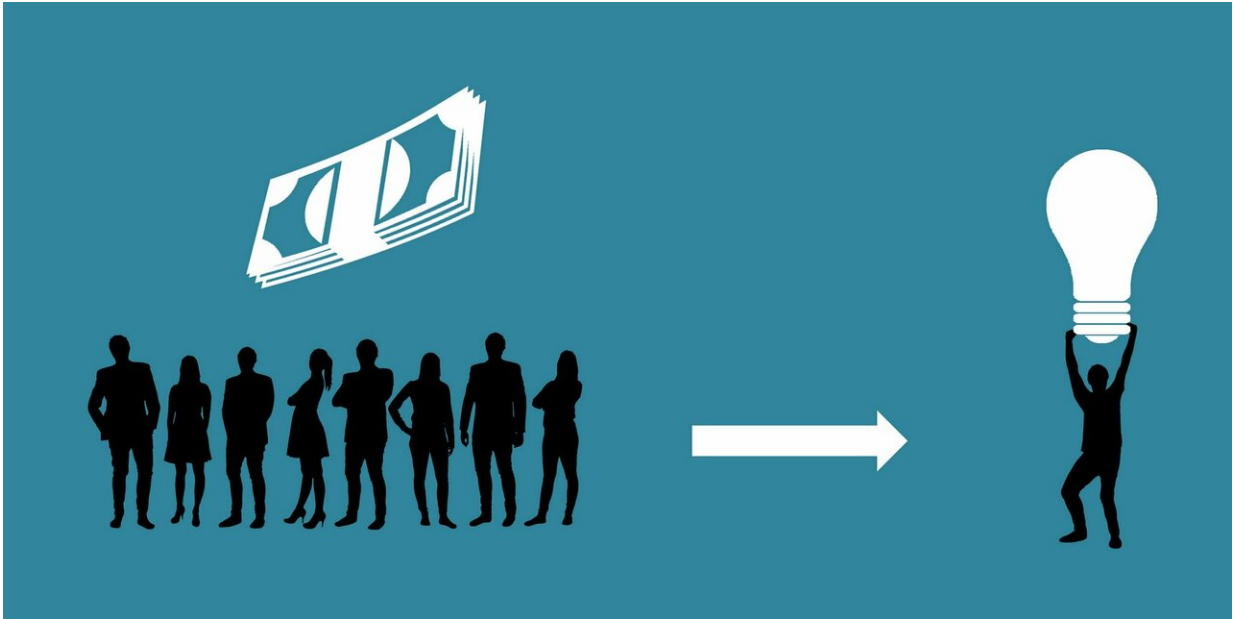


# Should crowdfunding be this complicated?

September 14 2022, by Courtney Ryan

---



Credit: CC0 Public Domain

In 2015, John Donovan was listening to a podcast when he learned about an entrepreneur who was hoping to start a business in the podcast space. Given the topic and audience, it would seem this entrepreneur could easily reach a large number of potential investors. However, U.S. regulations at the time prevented businesses from raising capital from non-accredited investors, i.e., individuals who aren't certified as high net worth.

"Back in 2015, if you wanted to raise capital from 'normal' people and

give them an [equity stake](#) in a company, you had to file [financial statements](#) with the SEC. You basically had to become a [public company](#)," said Donovan, assistant professor of accountancy and the PwC Faculty Fellow at the Mendoza College of Business at the University of Notre Dame. "You're talking about small companies that are looking for \$100,000 having to comply with the exact same regulations as a company like General Motors."

Following SEC regulations associated with the JOBS Act in late 2015, the rules changed based on the amount of capital being raised, but only slightly. Startups still must provide audited financial statements or hire an accountant to review financial statements before raising capital from common, non-accredited investors—all of which can become costly and complicated, though very little evidence exists to demonstrate the value of these requirements.

Prior to working in academia, Donovan was a certified public accountant at PricewaterhouseCoopers (PwC), where he became interested in startup finance. "It's a very important part of our economy. Job creation is largely driven by new companies emerging and access to capital for startup firms," he said. "Yet there's not a lot of evidence in our research examining the role accounting and [financial reporting](#) might play in that space, largely because data is really hard to come by. And here in the United States, we're mandating that [startups] not only provide it, but have it looked at by an accountant."

Donovan decided to go searching for data that could help determine the importance of accounting and financial reporting in the startup space. He outlined his research in the paper "Financial Reporting and Entrepreneurial Finance: Evidence from Equity Crowdfunding," published in *Management Science*.

While the U.S. has distinct regulations in place, Donovan found that the

United Kingdom was the complete opposite. "In the U.K., they were saying you can provide whatever information you want. It's all voluntary, it does not need to be audited or reviewed," said Donovan. "So I thought the U.K. was a really good laboratory to see what that market would look like outside of regulation. I wanted to see first, are firms disclosing this at all? And then if they are, to what extent does it actually matter to reduce information asymmetry and let investors know what's going on with the company? Are they even responding to this information? Does it help firms raise capital?"

To answer these questions, Donovan collected the data manually by tracking every firm listed in the U.K. on Crowdcube, the world's largest equity crowdfunding platform, over a three-year period to see how much capital they were actually raising and what information they had provided to investors to help raise that capital. His findings both supported and challenged a few repeated perceptions among startup investors.

"The commonly held belief is, 'Why would I care about a firm's assets or liabilities or existing historical revenues? I'm only worried about growth. I'm only worried about the future prospects of this firm,'" said Donovan. "I think what a lot of people have in mind is that every prospective tech firm wants to be the next Uber or Facebook or some huge growth app. But a lot of small businesses aren't that. About a quarter of my sample was actually food and restaurant firms. A huge number of startups, especially in this market, are just trying to do something simple like start a restaurant or source a new sustainable coffee."

Donovan's research showed that, contrary to popular opinion, financial reporting does indeed matter in the average case. Investors respond to having more financial detail and are more likely to contribute capital to firms that are providing financial reporting. However, it's not a one-size-fits-all statement. The firm's assets and liabilities tend to only really

matter after more mature firms have had some meaningful operations.

"It just makes sense," said Donovan. "If you only have one month of historical revenue or assets, that's not relevant. What I found was that at three years is when that information started becoming relevant. And that's about the median firm that's accessing this market in my sample."

Donovan also found that reporting historical information about assets, liabilities and revenues has an indirect positive effect on a startup's future since raising capital is linked to future asset growth. He suggested that entrepreneurs can use this information to reassess their relationship with accounting and consider having financial statements to provide to potential investors when raising capital.

He uses this study in his undergraduate accounting classes to help illustrate how important accounting is for successful entrepreneurs. However, he hopes others will recognize this area of research and its potential to improve entrepreneurs' access to capital in the U.S.

"In the U.K., this market has grown larger than private equity or VC. That hasn't happened here in the United States yet," Donovan said. "The big question is, are the regulations in the U.S. potentially hurting entrepreneurs? Is it too costly? And if so, what should the regulation of this market look like?"

**More information:** John Donovan, Financial Reporting and Entrepreneurial Finance: Evidence from Equity Crowdfunding, *Management Science* (2021). [DOI: 10.1287/mnsc.2020.3810](https://doi.org/10.1287/mnsc.2020.3810)

Provided by University of Notre Dame

Citation: Should crowdfunding be this complicated? (2022, September 14) retrieved 25 April 2024 from <https://phys.org/news/2022-09-crowdfunding-complicated.html>

This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.