

Capitalization Table Guidance Document

A Beginner's Guide for Small Business Owners

Setting up a capitalization table (cap table) is essential for tracking who owns what percentage of your company. This document simplifies the process of creating, maintaining, and reporting your cap table.

1. Setting Up Your Cap Table

Core Elements to Track

A basic cap table requires a simple spreadsheet to track four essential details for every equity holder:

- **Shareholder Name:** The legal identity of the owner.
- **Share Count:** The exact number of shares owned.
- **Ownership Percentage:** Shares owned divided by total issued shares.
- **Capital Invested:** The actual cash or asset value contributed.

2-Step Initial Creation

1. **List Founders:** Input initial share allocations and cash investments.
2. **Total the Baseline:** Sum all shares to establish your initial 100% ownership baseline.

Initial Setup Example

Shareholder Name	Share Type	Number of Shares	Ownership %	Capital Contributed
Founder A	Common Stock	600,000	60.00%	\$6,000
Founder B	Common Stock	400,000	40.00%	\$4,000
Total		1,000,000	100.00%	\$10,000

2. Tracking Changes and Dilution

As your business grows, you will issue new shares. This introduces **dilution**, meaning existing owners will see their ownership percentage decrease, even though their total number of shares remains the same.

Common Events to Record

- **New Investor Onboarding:** Adding capital in exchange for newly issued shares.
- **Equity Incentive Pools:** Reserving shares for future employee hires.
- **Transfer of Ownership:** Buying out a partner or transferring existing shares.

Post-Investment Example (Investor Buys 200,000 New Shares)

Shareholder Name	Number of Shares	New Ownership %	Impact Description
Founder A	600,000	50.00%	Percentage diluted from 60%
Founder B	400,000	33.33%	Percentage diluted from 40%
Investor C	200,000	16.67%	New shares issued for cash
Total	1,200,000	100.00%	Total share pool expanded

3. Reporting Equity on Your Balance Sheet

Your cap table details share counts, while your **Balance Sheet (Equity Section)** records the financial value of those shares. The total equity on your balance sheet must reflect the historical financial transactions tracked in your cap table.

3 Main Accounting Components

- **Common Stock:** The par value of your issued shares (typically a tiny fraction, like \$0.001 per share).
- **Additional Paid-In Capital (APIC):** The excess money investors paid over the par value of the stock.
- **Retained Earnings:** Cumulative net income or losses kept in the business.

Step-by-Step Balance Sheet Integration

1. **Calculate Stock Par Value:** Multiply total issued shares by your share par value.
2. **Calculate APIC:** Subtract the total par value from the total cash actually invested.
3. **Format the Equity Section:** Present these figures at the bottom of your balance sheet.

Balance Sheet Presentation Example

Assuming 1,200,000 shares issued at a \$0.01 par value, with \$50,000 total cash invested and \$15,000 in retained earnings:
Stockholders' Equity:

- Common Stock (\$0.01 par value, 1,200,000 shares authorized and issued): **\$12,000**
 - Additional Paid-In Capital (APIC): **\$38,000**
 - Retained Earnings: **\$15,000**
 - **Total Stockholders' Equity: \$65,000**
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4. Handling Convertible Notes and SAFE Agreements

Startups often raise early-stage capital using **Convertible Notes** and **Simple Agreements for Future Equity (SAFEs)**. These instruments delay valuing the company until a future priced equity round. However, they are treated differently on both your **Cap Table** and your **Balance Sheet**.

Cap Table vs. Balance Sheet Treatment

Feature	Convertible Notes	SAFE Agreements
Cap Table Status	Potential future shares (unissued)	Potential future shares (unissued)
Dilution Impact	Dilutes owners <i>only</i> upon conversion	Dilutes owners <i>only</i> upon conversion
Balance Sheet Classification	Venture Debt (Liability)	Deferred Equity / Equity Component
Interest Accrual	Yes (increases liability over time)	No interest
Maturity Date	Yes (must be repaid if not converted)	No maturity date

1. Tracking in the Cap Table

Convertible notes and SAFEs do not grant immediate share ownership. They represent a contractual right to **future shares**.

3 Rules for Cap Table Management

1. **Do Not Issue Shares Yet:** Keep these agreements in a separate ledger or footnote. Do not add them to your active share count pool.
 2. **Track the Pro-Forma Dilution:** Use a "fully diluted" view model to calculate what ownership *will* look like once these instruments convert.
 3. **Log the Conversion Triggers:** Note the valuation caps, discount rates, and minimum funding amounts required to trigger conversion.
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2. Reporting on the Balance Sheet

Because these instruments carry different legal obligations, they require separate accounting classifications on your balance sheet.

Convertible Notes: Venture Debt Treatment

Convertible notes are formal debt obligations. They must be reported under **Liabilities** until they convert or are repaid.

1. **Principal Investment:** Record the cash received as a **Long-Term Liability** named "Convertible Notes Payable."
2. **Interest Accrual:** Calculate annual interest. Record it as an expense on the income statement and increase "Interest Payable" under **Current Liabilities**.
3. **Conversion Event:** When notes convert to stock, remove the liabilities. Reallocate the principal and accrued interest to **Common Stock** and **APIC** in the Equity section.

SAFE Agreements: Deferred Equity Treatment

SAFES generally lack maturity dates and do not accrue interest. They do not represent a traditional liability and are classified within the **Stockholders' Equity** section.

1. **Principal Investment:** Record the cash received under Equity as a distinct line item named "**SAFE Investment**" or "**Deferred Equity**".
 2. **No Maintenance Required:** Leave the balance untouched. No interest calculations are required over time.
 3. **Conversion Event:** When a priced round occurs, move the total SAFE balance out of Deferred Equity and reallocate it directly into **Common Stock** and **APIC**.
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Financial Presentation Example

The layout below illustrates how a **\$50,000 Convertible Note** and a **\$40,000 SAFE** appear alongside your baseline figures on a small business balance sheet:

Liabilities

- Current Liabilities:
 - Accrued Interest Payable: **\$2,000**
- Long-Term Liabilities:
 - Convertible Notes Payable (Venture Debt): **\$50,000**
- **Total Liabilities: \$52,000**

Stockholders' Equity

- Common Stock (\$0.01 par value, 1,200,000 shares): **\$12,000**
 - Additional Paid-In Capital (APIC): **\$38,000**
 - **Deferred Equity (SAFE Agreements): \$40,000**
 - Retained Earnings: **\$15,000**
 - **Total Stockholders' Equity: \$105,000**
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5. Step-by-Step Example: Converting a Note to Shares

When a company raises a formal "priced round" of funding (such as a Series A round), existing convertible notes automatically convert into actual shares of stock.

Below is a practical example of how a **\$50,000 convertible note** converts into equity, showing the exact calculations, cap table adjustments, and balance sheet updates.

Scenario Setup

- **The Note:** An investor holds a **\$50,000** convertible note with **\$2,000** in accrued interest (Total debt = **\$52,000**).
 - **The Note Terms:** The note converts at a **20% discount** to the new investor's share price.
 - **The New Investment:** A new venture capitalist agrees to invest money at a share price of **\$2.00 per share**.
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Step 1: Calculate the Discounted Conversion Price

Convertible note holders receive a lower share price than new investors to reward them for taking an earlier risk on the company.

- **Formula:** $\text{New Investor Share Price} \times (1 - \text{Discount Rate})$
- **Calculation:** $\$2.00 \times (1 - 0.20) = \1.60
- **Result:** The note holder buys shares at **\$1.60 per share**.

Step 2: Determine the Number of Shares to Issue

To find the share count, divide the total owed to the note holder (principal + interest) by their discounted conversion price.

- **Formula:** $(\text{Note Principal} + \text{Accrued Interest}) \div \text{Discounted Conversion Price}$
- **Calculation:** $\$52,000 \div \$1.60 = 32,500 \text{ shares}$
- **Result:** The company must issue **32,500 new shares** to the note holder.

Step 3: Update the Cap Table

The total pool of shares expands. The note holder moves from a footnote debt position into the active shareholder list.

Shareholder Name	Shares Before	Shares Issued	Shares After	Final Ownership %
Founders & Others	1,200,000	0	1,200,000	97.36%
Note Investor	0	32,500	32,500	2.64%
Total	1,200,000	32,500	1,232,500	100.00%

Step 4: Adjust the Balance Sheet (Journal Entries)

Upon conversion, the entire debt vanishes from the liabilities section. The value is permanently transferred into the stockholders' equity section.

The Accounting Reallocation

- **Remove Liabilities:** Reduce "Convertible Notes Payable" by **\$50,000** and "Accrued Interest Payable" by **\$2,000** down to zero.
- **Increase Common Stock:** Multiply the new shares by par value ($32,500 \text{ shares} \times \$0.01 \text{ par} = \$325$). Increase Common Stock by **\$325**.

- **Increase APIC:** Allocate the remaining balance to Additional Paid-In Capital ($\$52,000 \text{ total debt} - \$325 \text{ par value} = \$51,675$). Increase APIC by **\$51,675**.

Updated Balance Sheet Presentation

The debt lines disappear, and the equity lines absorb the \$52,000 value:

Liabilities

- Convertible Notes Payable (Venture Debt): **\$0** (*Removed*)
- Accrued Interest Payable: **\$0** (*Removed*)

Stockholders' Equity

- Common Stock (\$0.01 par value, 1,232,500 shares): **\$12,325** (*Increased by \$325*)
- Additional Paid-In Capital (APIC): **\$89,675** (*Increased by \$51,675*)
- Deferred Equity (SAFE Agreements): **\$40,000**
- Retained Earnings: **\$15,000**
- **Total Stockholders' Equity: \$157,000**

6. Calculating Pre-Money vs. Post-Money Valuation

When negotiating a priced investment round, you must understand the difference between **Pre-Money Valuation** and **Post-Money Valuation**. These two figures dictate exactly how much of the company you give away to new investors.

The Core Definitions

- **Pre-Money Valuation:** The agreed-upon dollar value of your company *before* you receive any new investment cash.
- **Post-Money Valuation:** The total dollar value of your company *after* the new investment cash is deposited into your bank account.

The Master Formula

$$\text{\$}\text{\textit{Post-Money Valuation}} = \text{\textit{Pre-Money Valuation}} + \text{\textit{New Investment Cash}}\text{\$}$$

Step-by-Step Practical Example

Let's look at a common scenario where a small business raises cash from a new venture capitalist.

Scenario Details

- **Agreed Pre-Money Valuation:** \$4,000,000
 - **New Investment Cash:** \$1,000,000
 - **Total Current Shares Outstanding:** 1,232,500 shares
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Step 1: Calculate the Post-Money Valuation

Using the master formula, add the new investment cash to the pre-money valuation.

$$\$4,000,000 \text{ (Pre-Money)} + \$1,000,000 \text{ (New Cash)} = \$5,000,000 \text{ (Post-Money)}$$

Step 2: Calculate Investor Ownership Percentage

To find out how much of the company the new investor will own, divide their cash contribution by the post-money valuation.

$$\text{Ownership \%} = \frac{\text{New Investment Cash}}{\text{Post-Money Valuation}}$$
$$\frac{\$1,000,000}{\$5,000,000} = 20.00\%$$

- **Result:** The new investor will own exactly **20%** of the company.
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Step 3: Calculate the Price Per Share

To find out what price the investor pays for each individual share, divide the pre-money valuation by the existing number of shares before the investment.

$$\text{Price Per Share} = \frac{\text{Pre-Money Valuation}}{\text{Current Total Shares}}$$
$$\frac{\$4,000,000}{1,232,500 \text{ shares}} = \$3.2454 \text{ per share}$$

Step 4: Determine the Number of New Shares to Issue

Divide the new investment cash by the calculated price per share to find out how many brand-new shares to print for the investor.

$$\text{New Shares Issued} = \frac{\text{New Investment Cash}}{\text{Price Per Share}}$$
$$\frac{\$1,000,000}{\$3.2454} = 308,128 \text{ shares}$$

Step 5: Update the Cap Table Ownership Summary

The cap table expands to include the new investor, showing that the original owners have been diluted down to 80% total ownership.

Shareholder Name	Shares Before	New Shares Issued	Shares After	Final Ownership %
Existing Shareholders	1,232,500	0	1,232,500	80.00%
New Investor	0	308,128	308,128	20.00%
Total	1,232,500	308,128	1,540,628	100.00%

7. Creating a Pro Forma Cap Table

A **pro forma cap table** is a forward-looking model. It projects what your company's ownership structure will look like *after* a future event occurs, such as a new funding round where SAFEs and convertible notes convert into shares at the same time a new investor buys in.

Building a pro forma cap table allows founders to see their exact final ownership percentage and understand the total dilution before they sign any final paperwork.

The Pro Forma Scenario

We will model a comprehensive pro forma scenario combining all the elements covered in this guide:

- **The Baseline:** 1,200,000 existing shares held by the founders.
 - **The SAFE:** One \$40,000 SAFE outstanding (converting at a 20% discount).
 - **The Note:** One \$50,000 Convertible Note + \$2,000 accrued interest (Total: \$52,000, converting at a 20% discount).
 - **The New Investment:** A new venture capitalist investing **\$1,000,000** at an agreed **\$4,000,000 Pre-Money Valuation**.
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Step-by-Step Pro Forma Calculations

To build the pro forma table accurately, you must run the math in a specific chronological sequence.

Step 1: Establish the Share Price for New Money

First, calculate the share price the new investor will pay based on the current existing share pool before any conversions take place.

- **Formula:** $\text{Pre-Money Valuation} \div \text{Existing Total Shares}$
- **Calculation:** $\$4,000,000 \div 1,200,000 \text{ shares} = \3.3333 per share

Step 2: Calculate the Conversion Price for Notes and SAFEs

Because both the SAFE and the Note have a 20% discount, their conversion price is lower than the new investor's price.

- **Formula:** $\text{New Investor Share Price} \times (1 - \text{Discount Rate})$
- **Calculation:** $\$3.3333 \times (1 - 0.20) = \2.6667 per share

Step 3: Determine Shares to Issue for Notes and SAFEs

Divide the total dollar value of each instrument by the discounted conversion price.

- **SAFE Shares:** $\$40,000 \div \$2.6667 = 15,000 \text{ shares}$
- **Convertible Note Shares:** $\$52,000 \div \$2.6667 = 19,500 \text{ shares}$

Step 4: Determine Shares to Issue to the New Investor

Divide the new cash investment by the new investor's share price.

- **New Investor Shares:** $\$1,000,000 \div \$3.3333 = 300,000 \text{ shares}$

The Final Pro Forma Cap Table

By putting all these pieces together into one master model, you create the pro forma cap table. This shows the transition from the historical starting point to the future post-funding structure.

Shareholder Name	Starting Shares	Starting %	New Shares Issued	Post-Round Shares	Final Pro Forma %
Founder A	600,000	50.00%	0	600,000	39.10%
Founder B	400,000	33.33%	0	400,000	26.07%

Previous Investors	200,000	16.67%	0	200,000	13.03%
SAFE Investor	0	0.00%	15,000	15,000	0.98%
Note Investor	0	0.00%	19,500	19,500	1.27%
New VC Investor	0	0.00%	300,000	300,000	19.55%
Total	1,200,000	100.00%	334,500	1,534,500	100.00%

Summary of Post-Round Balance Sheet Adjustments

Once this pro forma scenario becomes reality, the balance sheet equity section must be updated to match the final pro forma share numbers:

1. **Clear Liabilities:** The \$52,000 total balance for the Convertible Note and its interest payable drops to \$0.
2. **Clear Deferred Equity:** The \$40,000 SAFE balance drops to \$0.
3. **Increase Common Stock:** The company issued 334,500 new shares. At a \$0.01 par value, Common Stock increases by **\$3,345**.
4. **Increase APIC:** The total new capital arriving or converting equals \$1,092,000 (\$1,000,000 cash + \$40,000 SAFE + \$52,000 Note). Subtracting the par value leaves an increase to APIC of **\$1,088,655**.

Created for Startup Financial Plan to assist C Corporations

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