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BUSINESS ENTITIES

SELF ASSESSMENT FOR EARLY STAGE INNOVATION COMPANY

Paper 003-046

CONTENTS

Page

1. Getting Started On Self-Assessment 2
2. Three Year Incorporation Test 2
3. Six Year Incorporation Test 2
4. Australian Business Register Test 3
5. Gateway Test 3
6. Self-Assessment Statement - Gateway Test 4
7. The Principles Based Test 5
8. Assistance In Determinations For The Principles Based Test 5
9. The Principles Based Test Question 5
10. Investors and ESIC 6
11. Investment Readiness For An Early Stage Innovation Company 6
12. Investment Pitch For An Early Stage Innovation Company 6
13. The ESIC Process 7
14. Professional Advice 8

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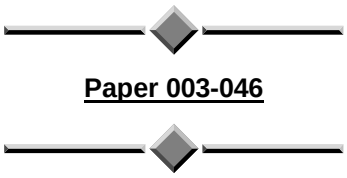

Paper 003-046

1. Getting Started On Self-Assessment

We recommend that you read Early Stage Innovation Company (Paper 003-045). This will give you an overview of the Early Stage Innovation Company Legislation. The key information that is required for the self-assessment process is:

- Australian Company Number
- Date of Incorporation
- Australian Business Register Registration Date (if the business is not a company registered in the last 3 years or a company registered in the last 6 years).

The test time, is the date that the Eligibility Checklist is being prepared to determine whether the company is eligible for the status of "Early Stage Innovation Company".

2. Three Year Incorporation Test

- This is the first of the preliminary tests. Was the company incorporated in the last 3 years?
- If so, was expenditure for the company and its 100% subsidiaries under $1M in the income year before the current year? A File Note substantiating how this calculation was made will need to be filed for potential tabling for a potential investor.
- Was assessable income for the company and its 100% subsidiaries under $200,000 in the income year before the current year? In determining the assessable income you can deduct any grant income received under an Accelerating Commercialisation Grant as this is specifically excluded from assessable income for the purposes of determining whether the company is eligible to self-assess as an Early Stage Innovation Company.
- Was The Company Listed On A Stock Exchange Anywhere In The World?
  If it was the company will be unable to self-assess as being an Early Stage Innovation Company.

  If the company has successfully answered these questions, you will then be able to move onto the Gateway Test questions (Item 5).

3. Six Year Incorporation Test

Another part of the preliminary tests is the 6 Year Incorporation Test. Was the company incorporated in the last 6 years?

The next question related to what the company has done in the last 3 years.

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Was total expenditure less than $1M for the company and its 100% subsidiaries?

Was assessable income for the company and its 100% subsidiaries, excluding any grant income from Accelerating Commercialisation, under $200,000?

Was the company listed on any Stock Exchange anywhere in the world? If the company was, it's unable to register as an Early Stage Innovation Company.

If the questions in this section have been correctly answered, the review process can then move to the Gateway Test (Item 5).

4. Australian Business Register Test

If the company is not eligible under the 3 year or 6 year tests, the company may be able to self-assess as an Early Stage Innovation Company if the company was registered in the Australian Business Register in the last 3 years.

Did the company and its 100% subsidiaries (if any) incur total expenses of $1M or less in the income year before the current year?

Did the company and its 100% subsidiaries (if any) have a total assessable income of $200,000, excluding any grant funds from an Accelerating Commercialisation grant?

Were any of the companies' equity interests listed for quotation in the official list of any Stock Exchange in Australia or a foreign country?

If the correct answers have been submitted, you can now move to the Gateway Test Item 5.

5. Gateway Test

The Gateway Test raises a number of questions in relation to particular aspects of an innovation process that the company can earn points for. To be successful under the Gateway Test, the company must accumulate 100 points or more. The items that contribute to points being earned are as follows:

- Research and Development Expenditure.
  If the R & D expenditure exceeds 50% of the company's total expenditure in the income year being reviewed, the company will earn 75 points. If the research and development expenditure was 15% to 49% of the company's total expenditure, the company would earn 50 points. It will be important that a supporting schedule is prepared which identifies the amount of research and development that has been claimed in the company's income tax return and ensures that this is the amount used in this calculation.

- Accelerating Commercialisation Grant
  Has the company received support from an Accelerating Commercialisation Grant administered by the Entrepreneurs Programme?

  This grant could have been received at any time during the 3 year or 6 year period.

  If the company has received an Accelerating Commercialisation Grant, the company will earn 75 points.

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- Accelerator Programme
  If the company has completed or is it currently undertaking an Accelerator Programme, 50 points can be earned if the company is or has participated in an Accelerator Programme, but supporting evidence will have to be obtained from the organisation conducting the Accelerator Programme.

- Arms-Length Investors
  Has the company received, at least, $50,000 in share capital subscriptions from arms-length investors and have the company's directors signed a declaration that the new shareholder(s) was not an associate immediately before the investment or the shares were not acquired to assist another entity to become entitled to a tax offset? The points able to be earned are 50.

- Patents
  Does the company own a patent or plant breeder's right? This claim will have to be supported by appropriate documentation. 50 points can be earned if either of these items is registered in the company's name.

- Innovation Patent
  If the company holds an innovation patent or a registered design 25 points can be earned. Supporting evidence will need to be assembled to confirm that the company does hold these registrations.

- Agreements to Commercialise Products etc
  If the company has entered into written agreements to co-develop and commercialise a new or significantly improved product, process, service, marketing or organisational method with organisations listed in Schedule 1 to the Higher Education Funding Act 1938 or with organisations registered under Section 29A of the Industry Research & Development Act, the company can earn 25 points.

If the total of the points under the Gateway Test amounts to 100 points or more, the company has successfully self-assessed as an Early Stage Innovation Company.

6. Self-Assessment Statement - Gateway Test

The company directors could then sign a statement certifying that the company has undertaken a self-assessment process and that the directors are satisfied that the company qualifies as an Early Stage Innovation Company identifying the items that the company has earned points for.

It is very important however that full supporting evidence is maintained of the documentation to support the self-assessment status because investors will undoubtedly require to sight that documentation prior to making any investment in the company.

The self-assessment process will also undoubtedly be required for the company to satisfy the Australian Taxation Office's requirements when the company lodges its income tax return that the company is an Early Stage Innovation Company.

If the company has accumulated less than 100 points, it is then necessary to move to the Principles Based Test (Item 7).

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7. The Principles Based Test

There are 5 questions which must all be answered positively and be able to be supported for the company to be able to self-assess as an Early Stage Innovation Company relying on the Principles Based Test.

8. Assistance In Determinations For The Principles Based Test

Most companies will need assistance from an arms-length independent organisation that the company has satisfied the requirements set out in the Principles Based Test.

This will be very important as part of the process of convincing investors that the company has appropriately self-assessed under the Principles Based Test and undoubtedly similar enquiries will be made by the Australian Taxation Office when the company lodges its income tax return if the company is claiming the Early Stage Innovation Company status relying on the Principles Based Test.

9. The Principles Based Test Question

The questions that have to be answered positively if the company is going to be able to self-assess under the Principles Based Test are:

1. Is the company genuinely focused on commercialisation of products, processes, services, marketing or organisational methods? Documentation will have to be prepared and filed so the documentation can be produced to support the statement the company is making.
2. Does the company have high growth potential? This is a question that undoubtedly is going to require support from an independent organisation that the company's products, processes, services, marketing or organisational methods are of such a magnitude that the company does have a high growth potential.
3. Can the company successfully scale the business? This question will require the company to be able to identify how it will be able to 'scale' the company's operations in Australia and elsewhere.
4. Do the company directors have supporting evidence that the company's products, processes, services, marketing or organisational methods have broader than local market opportunities? The company will undoubtedly require input from external consultants identifying how the company will be able to identify and then successfully market at an appropriate price the company's products etc., in international markets.
5. Does the company have a competitive advantage? The answers to this question will need to be documented so that the answers are available for perusal by potential investors and ultimately the Australian Taxation Office.

If the directors are able to sincerely answer yes to each of these questions and appropriately support the answer with documentation, the company could then prepare a statement relative to self-assessment as an Early Stage Innovation Company satisfying the Principles Based Test for submission to potential investors. The statement should be signed by the company's directors and be available for inspection by potential investors and the Australian Taxation Office.

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10. Investors and ESIC

The Early Stage Innovation Company's legislation under the Income Tax Act is giving young companies the opportunity to raise capital from arms-length investors that traditionally had not been available to Australian companies.

The assessment requirements to be deemed to be an Early Stage Innovation Company are onerous because not only is the company receiving the opportunity to be able to raise capital in a method that traditionally companies could not do so in Australia, but investors are going to be entitled to a tax offset calculated at 20% of their investment in a company in a year up to an amount of $200,000 to a sophisticated investor and $10,000 available to a retail investor.

A sophisticated investor is a person who a practicing accountant has certified has a net worth of, at least, $2.5M or has earned assessable income of, at least, $250,000 in each of the last two years.

The maximum investment for a retail investor into an Early Stage Innovation Company is $50,000.

Investors will also obtain capital gains tax exemption on the shares that have been issued to them if they hold those shares for more than 12 months and less than 10 years.

11. Investment Readiness For An Early Stage Innovation Company

Once the self-assessment process has been concluded, it will then be necessary to ensure that the company has prepared the documentation that will identify the commercial opportunities available for the company and hopefully will encourage investors to invest in the company by acquiring shares. It is suggested that you read "Investment Readiness ESIC" (Paper 040-010).

Investment readiness requires the following documentation to be prepared:

- details of company officers including directors, secretary, CEO, CFO
- business planning assignment including identification of consultants to prepare individual reports relating to items such as:
  - Market Research
  - Export Market Research
  - Marketing Plan
  - Intellectual Property Report
  - Management Team
  - Working Prototype
  - Proven Technology
  - Legal Advisers Report

It will then be necessary to prepare budgets and cashflow forecasts and a business plan for the business, as well as the business valuation and a share pricing report. Once the directors have finalised these reports, the company's Information Memorandum prepared in accordance with the requirements of the Corporations Code will be required to be prepared.

12. Investment Pitch For An Early Stage Innovation Company

It is recommended that you read "Investment Pitches for ESIC" (Paper 040-096).

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The preparation for an investment pitch is a very important process for companies which are aspiring to be deemed to be Early Stage Innovation Companies have to undertake. Most companies that will be deemed to be Early Stage Innovation Companies will have to make investment pitches to potential investors. The comments within "Investment Pitches for ESIC" (Paper 040-096) convey suggestions on the preparation process and actual presentation techniques for the making of a successful investment pitch to potential investors.

One of the key things to remember in making investment pitches is to clearly identify the WOW factor of this company. Within the investment pitch the presenter should also clearly identify that the company's directors are satisfied that the company's self-assessment that the company is an Early Stage Innovation Company, has been appropriately conducted.

Other key items to be summarised in the investment pitch include:

- Products, processes and services that the company has available for sale
- Differentiation from the company's competitors
- What are the markets that the company plans to operate in?
- Who are the potential customers?
- Customers' testimonials (if available)
- Who is the management team?
- Who are the directors?
- A summary of the intellectual property that is owned by the company
- The amount of capital that is to be raised
- The number of shares that will be issued

The financial projections showing sales, gross profit, overhead expenses, projected net profit for the next 3 years.

The company will need to identify investor groups that are operating within their location so that contact can be made relative to presenting investment pitches.

These groups include:

- Business Angel Groups; and
- Founders' Forum

13. The ESIC Process

The government has established this legislation to encourage companies that are reasonably young to identify the company's business activities and to be able to honestly answer the Gateway Test or the Principles Based Test to determine whether the company can self-assess that the company is an Early Stage Innovation Company.

This will be a very important process to attract investors.

Whilst the legislation indicates that the company's directors can make an application to the Australian Taxation Office to determine whether the company is able to be assessed as an Early Stage Innovation Company, this is expected to be a slow process and the company will undoubtedly have to submit the same type of documentation to the Australian Taxation Office that has been summarised in this paper.

Most companies will be anxious to try to raise the capital so they can get on with their business operations and therefore the suggested approach is that the company honestly self-assesses and maintains all supporting documentation so that the self-assessment process and the associated documentation is available for review by potential investors.

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These documents will undoubtedly be required when the company submits its income tax return at the end of the first year to satisfy the Australian Taxation Office that the company is an Early Stage Innovation Company.

However, obtaining the status of an Early Stage Innovation Company is only part of the process. The company then has to complete the investment readiness phase which relates to the preparation of budgets, cashflow forecasts, business plans with supporting documentation and information memorandum and associated documents for submission to investors. The company's CEO has to then be able to confidently present investment pitches to potential investors.

Accountants/advisers can assist companies on this journey with the preparation that's going to be needed for companies that aspire to be Early Stage Innovation Companies to be able to successfully raise capital from investors.

14. Professional Advice

If you require any advice relative to Early Stage Innovation Companies, please do not hesitate to contact your professional accountant/advisor.

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