frog capital

Scale-Up Toolkits

Budgeting in a fast-growing business

This toolkit includes:

- Steps for developing the finance function
- An overview of the finance function from the CEO's perspective
- A detailed approach to finance function development

www.frogcapital.com/scale-up-methodology

Introduction

I have often heard from finance people within early stage VC-backed businesses that forecasting is impossible as there are too many variables and there is not enough track record to understand how these variables will move.

They'll argue it isn't worth the effort given the fact that the outcome will always be different from the forecast. This rationale can be extended to justify a very limited budgeting process or, in extreme cases, to explain why no budget exists.

It's an easy mistake to make and a common one for start-ups moving towards scale-up. It indicates that leaders within these businesses may misunderstand the purpose of a budget and that those in charge of the finances aren't at the right level to drive decision making in their company. See my previous post on the need for a high quality CFO at an early stage for more on this.

The Company Budget is not primarily a financial exercise and it should not be about constraining or restricting the business expenditure; though it might be in large dysfunctional organisations where budgets are imposed on divisional managers. Believing budgets constrain ambition is a common perception for early stage tech CEOs but this is unfair if the process is done well.

Instead, the budget process needs to operate as a unifying process; it should be owned by the whole company, not just the finance department. It should involve top-down input from the board and bottom-up input from departmental managers, to create an output that is internally consistent, matching goals with the resources required to achieve them. It should be built on a financial model that can flex both up and down to better manage these possible outcomes.

> **"Senior management and the board need to agree on the key drivers of the business in order to achieve this alignment."**

A good budget should:

01 Align resources with strategy

This includes strategic non-financial objectives such as increasing client satisfaction. Senior management and the board need to agree on the key drivers of the business in order to achieve this alignment. An honest appraisal of strategic goals needs to take account of the addressable market and current resources. Resources required to outperform the budget should also be clear.

02 Plan for bottlenecks and obstacles to growth

Whether it's step change OPEX investment, sales team expansion, an IT upgrade or marketing, scaling-up isn't a linear process. A good budget should account for this and understand where there are diminishing returns (e.g.marketing) or incremental unit costs.

03 Act as an effective yardstick for future performance

Learning from analysing actual outcome variances to budget will both improve future assumptions and understanding of causal connections and foster a better understanding of the current business drivers. Performance expectation must be built up from KPIs, enabling management to drill deeper into the underlying cause of a miss; e.g. for sales is it productivity per sales person, sales conversion rates, average order value, churn rates, or another factor not yet measured as a KPI?

04

Help a CEO manage expectations internally and externally

A budget should highlight upside/downside risks and opportunities and anticipate required reactions. An efective budgeting model should outline in advance the triggers to action (for example, revenue miss triggering a cost reduction or the reallocation of resource). This drives better scenario planning, giving the board options to choose based on risk and return. It will also help to reduce the likelihood of ruhed, reactive decision making when quick action is required.

05

Avoid being overly optimistic

In my experience, there is almost always a starting over-optimism in estimating the speed and risk of getting in new resources and forecasting how quickly they will have an impact. This requires sensible challenge and debate based on past experience drawn from within and outside the organisation.

06

Support proactive cash management

It is essential that all budgets include P&L, balance sheet and cash fow and therefore variance analysis for all three. This provides early visibility of potential and developing issues and allows proactive cash management required to maintain headroom. Rolling forward the variances against your forecasted budget will help senior management identify when to act (e.g. by accelerating fundraising or cutting costs) to make a diference in time. Being proactive early on small issues avoids them becoming big issues. It also builds confdence of investors and bankers, making fundraising easier.

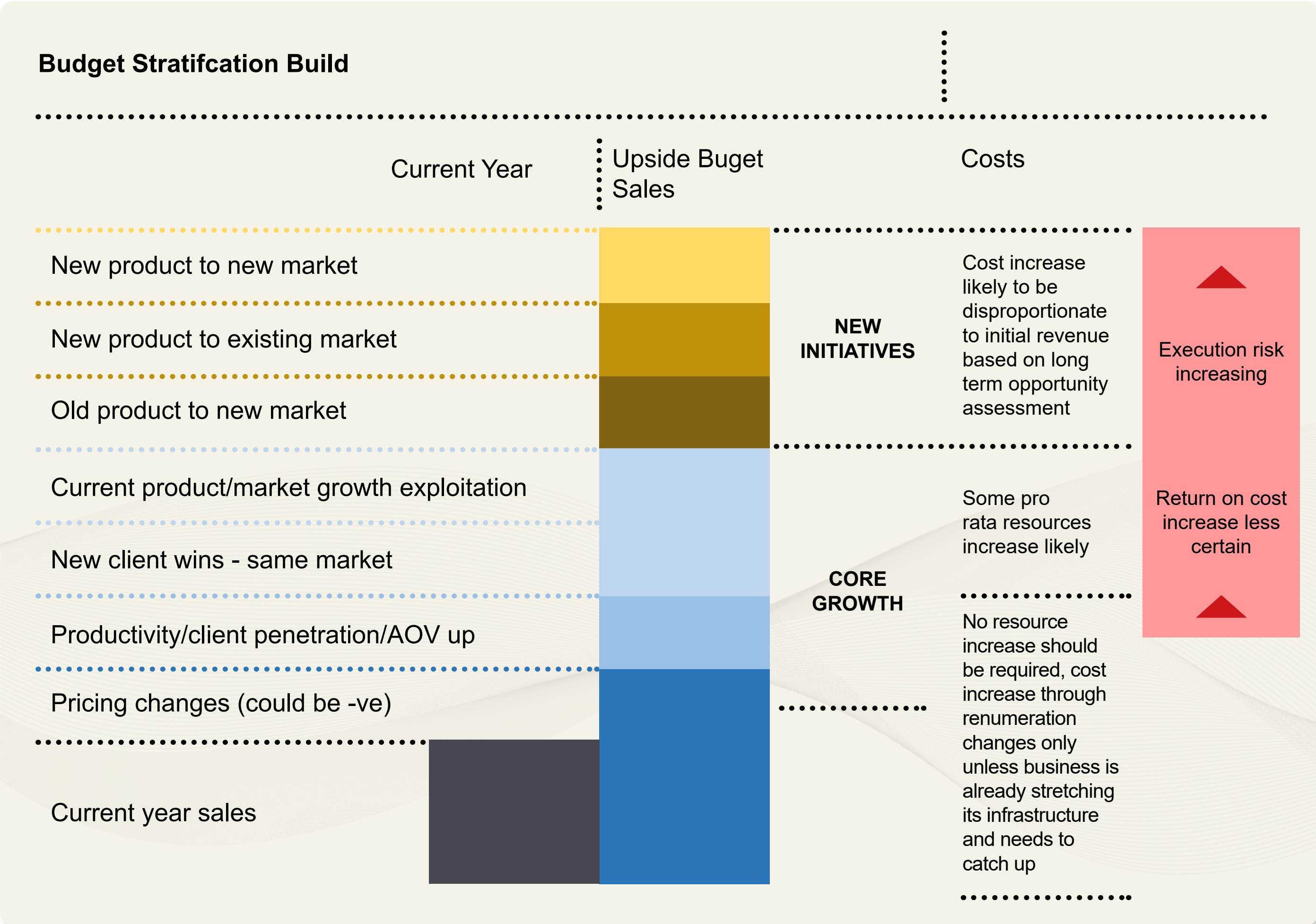
The budget process should be an exercise in getting the whole company to better understand the interconnectedness of its diferent parts and ultimately, to be better prepared to address the inevitable variances from the forecasted budget by providing a structure to assess them against. Without this structure, diferences can be explained with ad hoc stories that doesn't inform future resource allocation decision making and doesn't ensure accountability.

It should include appropriate headroom at all levels, never assuming all will go exactly to plan. In my previous CFO role at Syscap, for example, sales numbers in the budget were set 10% below the sales department target. Individual sales targets were set to aggregate at 10% above the sales department targets so that if, was usually the case, a quarter of sales people underperformed, the department as a whole would still hit budget given the headroom in excess of 20%.

Whilst it's true the early stage budget will be the most difficult due to lack of evidence, the budget process should improve with more information every year, but only if it is done properly from the start to provide a basis for learning.

> **"Rolling forward the variances against your forecasted budget will help senior management identify when to act."**

A generic budget approach is shown below:



With more evidence over time, revenue in the budget will be towards the bottom half of the build-up, but even the top half can be based on clear assumptions (which can then be tested and revised) around size of market, market penetration, pricing strategy.

The process starts with a roll forward budget of what can be achieved with current cost base from bottom up input and then assess the gap to top down level. The discussion should then focus on categorising departmental base cost increase requests between essential, desirable and unjustifed. The latter can be rejected and clear identifcation between the remaining two allows a clear view of potential outcomes and risks involved.

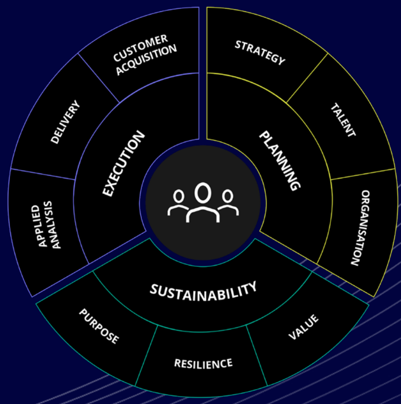
Ultimately the board needs to have the information available to decide where the sales budget is pitched and what level of risk that entails. At Frog, we recommend a budget based on acceptable risk (P85 - 85% probability of achievement), based on market visibility and degree of faith in ability of executive team to deliver on sales for assumed cost increases and desired progress towards proftability.

With this approach, some projects excluded from budget become the upside case. It is clearly still valid a for a Board to go with more ambitious budget but recognising this might be only a P70 puts a greater onus on knowing in advance (i) what is the fall-back plan if not delivering and (ii) what are the clear trigger points to allow this call to be made quickly before cash burn becomes too great.

At Syscap we presented it the other way with a base case budget (P90+) and then an upside case based on specifc projects that could be executed in the year or not depending on performance and opportunity. Either approach is acceptable as long as the risk/reward decision being made by the Board is proactive from a position of knowledge.

> **“The process starts with a roll forward budget of what can be achieved with current cost base from bottom up input and then assess the gap to top down level.”**

Budget Timing



Year end minus 4 months:

Syscap was a December year end so the Budget process started in September with an 8 (actual) +4 (forecast) full year forecast (P&L and Cash), providing current year variance analysis v budget, lessons learnt for future budgeting and identifying what needed to be diferent next year and how is that going to be implemented? The board should review or renew the 3-year plan, providing clarity on 3 year objectives and then have a strategy review to provide high level objectives for the following year consistent with the 3-year plan, identifying what needs to change to deliver strategy and task senior management to address them.

Year-end minus 3 months:

Senior management are asked to provide detailed proposals for high level projects e.g. IT or product upgrades, new products, new markets. All proposals should be peer reviewed to agree priorities. CFO and CEO outline the strategic objectives with key sales heads to align on opportunities and threats and then request departmental bottom up budgets and understand the gaps to top down; iterate to agreed compromise on sales resources and outcomes. Sales to provide their bottom up account management and sales plans for peer review and challenge. Discuss sales growth investment options and prioritise the potential upside opportunities. Projects and sales initiatives are then discussed with operational functional heads to assess limitations with current resources and new resource requirements. Challenge and iterate on assumptions made and degree of personal accountability being shown before forwarding to board for review. Re-prioritise projects based on cost beneft analysis.

Year end minus 1 months:

Further work with management team to fne tune budget and agree the P85 version for sign of. December board meeting budget sign of.

Following this process need not be time consuming, it should be a series of focused meetings getting quality input at the right time to evolve the budget and business thinking.

It certainly should not involve lots of large meetings, mostly it will be project managed by the fnance department direct with contributors, the CEO sitting in on any meetings where the discussions have progressed sufciently to be moving towards a conclusion.

The outcome will be clarity on what the business is trying to achieve in the year and a detailed framework to assess variances as part of a continuous improvement in both how the business operates and how forecasts are made. Hitting budget is not in itself an objective; doing the best you can is but having a framework to understand what drove good outcomes and what could be improved will be essential to doing the best you can over multiple years. This insight is relevant to any business at any stage with any growth rate and in my experience a no brainer as to the payback on the work required.

Execution **Planning** **Sustainability**

Customer Acquisiton | Delivery | Applied Analysis | Strategy | Talent | Organisation | Funding | Resilience

Frog Capital Ltd
The Mews, 1A Birkenhead Street
London WC1H 8BA
See more at www.frogcapital.com/scale-up-methodology