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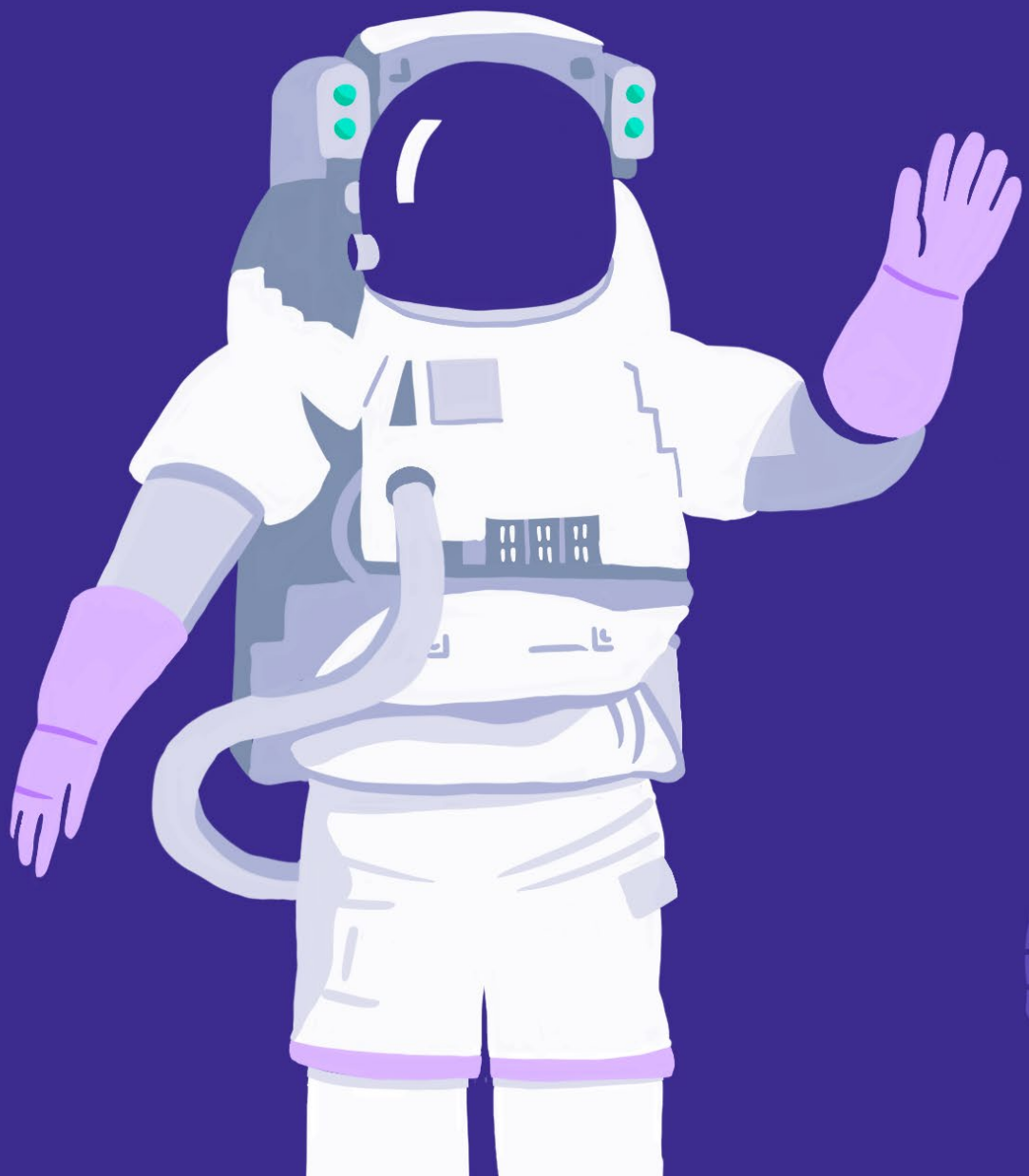
So You've Founded a Tech Startup:

A Guide to Setting Up for Success



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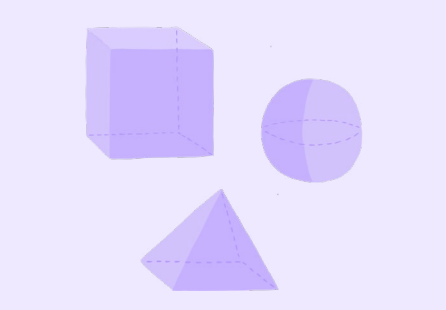
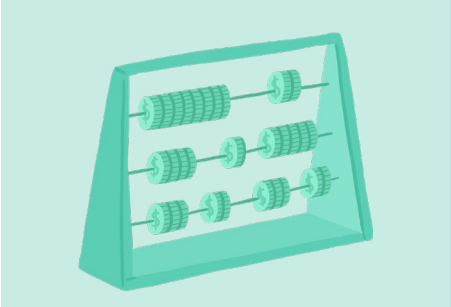
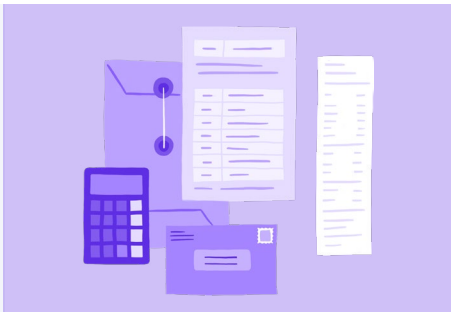






Introduction

If you're reading this, odds are you've just founded a tech startup (or you will soon). Congratulations! You've got an exciting road ahead of you.

As you're probably discovering, however, it's not enough to have a great product, or even a solid business plan. Running a day-to-day business involves a lot of moving parts, in areas you may not be particularly familiar with. **That's why we wrote this guide to help.**

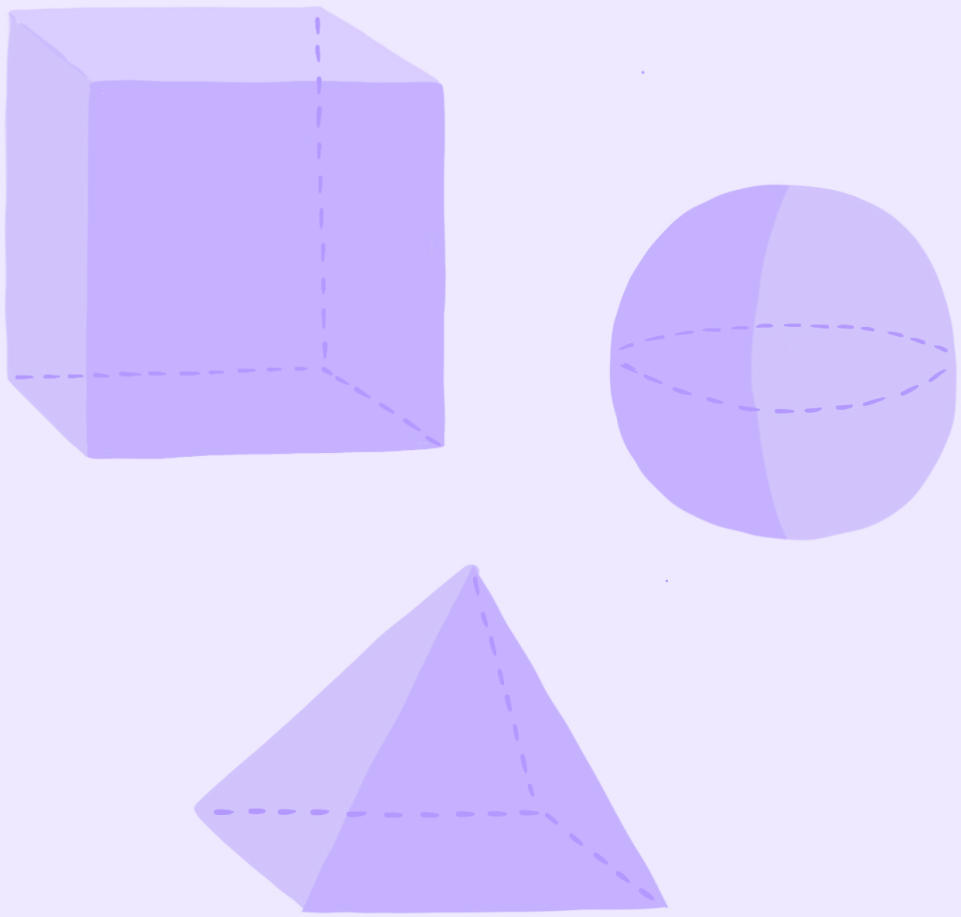
What this guide is:

A place to start. In this book we'll go over the fundamentals for running a business, how to understand and use your business data, managing taxes, and more. Besides our founders' personal experience in starting three successful companies, we've also helped over a thousand companies with their financials, including a large number of startups.

This book will share the answers to the most frequent questions we get from our startup customers, along with tips and recommendations based on our firsthand experience of what works and what doesn't.

What this guide isn't:

Financial, tax, or legal advice. We're a team of startup finance enthusiasts, not lawyers, financial advisors, CPAs, or tax preparers. For advice on your specific situation, you should always consult an appropriate professional (like your lawyer).



The Fundamentals

For any new business, there are a few things that need to be done right from the very beginning. Here are the non-negotiables to master before moving on to anything else.

01

Value Your Time

This may seem like a strange way to start off a list of business advice, but it's actually an important lesson many founders learn the hard way.

As a founder and a business leader, your time is the most valuable resource you have, and it will only grow more in-demand as your company grows.

Watching your runway start to burn down is stressful, and many first-time founders are inclined to DIY as much as possible in order to save money (particularly if their company is bootstrapped). And in some cases, particularly for very early startups, this can make sense. But it's crucial to keep in mind that while you don't have to pay out money for things you DIY, they aren't free. Instead of paying in cash, you pay in time and opportunity.

There are only so many hours in a day, and even the most hustle-dedicated founder has to sleep sometime. This is where valuing your time appropriately comes into play. If you spend it doing one thing, then you aren't spending it doing something else. So if you spend your time trying to personally handle all the details of every business management function - from HR to bookkeeping to payroll to IT - then you aren't spending that time on building your product, bringing it to market, and strategizing for growth. Your time isn't worthless - and you shouldn't treat it like it is.

A piece of advice we'll repeat often in this book is to recognize functions where DIY will be more trouble than it's worth, and bring in a professional service to manage them for you. The time and productivity savings will almost always be worth the cost.

02

Commingling: Just Say No

In the do's and don'ts of business, one of the biggest don'ts is commingling, i.e. mixing business and personal money.

If you're just starting out (and particularly if you're bootstrapping), it can be tempting to give in to the convenience of swiping your personal credit card or writing a personal check for your business expenses. Resist that temptation - it may be easy now, but it's setting you up for big problems later on.

There are various legal reasons that commingling is a bad idea, but one of the biggest ones is taxes. Many business expenses are tax-deductible, but identifying those expenses will be much more difficult if they're in the same account as your personal money. Some expenses, like equipment or SaaS licenses, may be obviously business-related. Other expenses, however, might be harder to identify after the fact.

At best, commingling sets you up for a painstaking grind at tax time, carefully reviewing each and every receipt to flag and confirm which expenses were for the business (and why).

At worst, you're liable for potentially significant tax penalties. If you get audited, the IRS will want (and expect) a bright line between your personal and business spending. A commingled account would get things off to a very unpromising start.

One more reason not to mix your money: it makes it hard to track how your business is actually performing. Since commingled accounts reflect both business and personal spending, it's not immediately clear how much money the business is spending or bringing in. It's also not clear how much cash in the account belongs to the business - a crucial factor in keeping an eye on your runway.

As soon as your business is officially established as a legal entity, it should have its own dedicated bank account and credit card.

03

Use Financial Best Practices from the Very Start

There's more than one way to keep financial records, but not all are equally good for your business. Take the time to set up your accounts and records using best practices from the beginning. Not only will it make it easier to manage your business, but you'll also prevent future switching pains once your business is off the ground.

BEST PRACTICE #1

Double-entry bookkeeping

The industry standard for bookkeeping. Dating back to at least the Renaissance, this system records two sides of every transaction, in two different accounts: one showing money leaving or entering an account, and another showing the same amount entering or leaving a different account.

Among other benefits, double-entry books provide safeguards against mistakes (or fraud). All serious businesses use double-entry books, and as part of GAAP (Generally Accepted Accounting Principles) it's a legal requirement for public companies.

While you technically could do this by hand in a spreadsheet (see next page), it's unlikely to be the best use of your time. You'll probably be better off using a software solution like QuickBooks, which has the added benefit of being an industry standard.

How Double-Entry Bookkeeping Works

For every transaction, your double-entry books record the amount entering or leaving one account, and leaving or entering another.

A simple example: if you purchase a chair for $100, the records will show $100 leaving your cash account, reflecting that you paid out money. You'll then also record the same amount entering an asset account, to reflect that you now own a chair worth $100. The accounts are balanced when each transaction shows corresponding debit and credit entries.

Here's a side-by-side comparison of what the same transactions look like, in both systems.

Double-Entry		
Account	**Debit**	**Credit**
Cash	-	$2,100
Equipment	$100	-
Rent	$2,000	-
Totals	**$2,100**	**$2,100**

Single-Entry	
Month Start	**$6,000**
Equipment	-$100
Rent	-$2,000
Month End	**$3,900**

One of the reasons that double-entry bookkeeping cuts down on mistakes is that the totals have to match. In single-entry bookkeeping, there's no way to tell if an incorrect amount was entered by mistake. In double-entry bookkeeping, it's easier to tell something is wrong: if you make a mistake, the accounts won't balance,

Here's an example: in the chart on the right, the two totals don't match up, so the bookkeeper can immediately see that something is wrong.

Looking closer, we see that $300 entered the equipment account, but there's no corresponding amount leaving the cash account. When the transaction was recorded, the cash entry was mistakenly left out. In single-entry accounting, this wouldn't be clear - there would just be a surprise when the next bank statement showed $300 less cash than expected in the company's account.

Double-Entry		
Account	**Debit**	**Credit**
Accounts Receivable	-	$4,000
Cash	$4,000	-
Equipment	$300	-
Totals	**$4,300**	**$4,000**

BEST PRACTICE #2

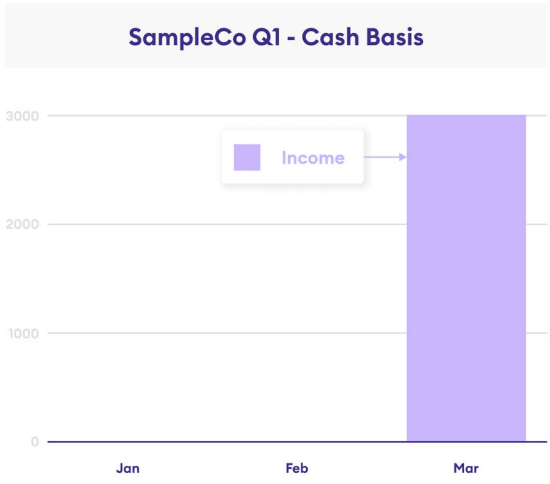
Accrual-basis accounting

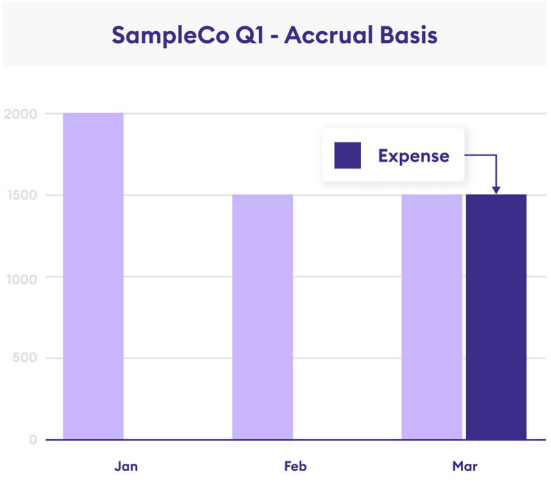
Your accounting can be done either on a cash basis, which records transactions when money is paid out, or an accrual basis, which records transactions when they occur. Like double-entry bookkeeping, accrual-basis accounting is industry-standard, and you should use it from day one.

While cash-basis accounting can sometimes be simpler, accrual-basis gives you a better view into your business's health. For companies that have inventory or make more than $25M in sales revenue, the IRS actually requires it.

Let's look at an example scenario: Q1 for SampleCo.

SampleCo made 10 sales in Q1, for $500 each: 4 sales in January, 3 sales in February, and 3 sales in March. Each sale had net-60 payment terms, and SampleCo received payment in March from 6 customers. Additionally, SampleCo made a software purchase for $1,500 in March. The purchase had net-30 payment terms, and by the end of March SampleCo was still processing the invoice.





Cash-basis and accrual-basis show very different views of SampleCo's Q1.

Cash-basis accounting shows us how much money went into SampleCo's bank account in Q1. While this is important information to know, it's not the whole story. If we just go by the cash-basis chart, we see a large cash deposit in March, but nothing in January or February. We don't have any insight into how many sales SampleCo is making, or how often. For all we know, they could have struggled all quarter and then made a single large sale. For a potential investor or lender, there isn't enough information here to make an informed funding decision.

Accrual-basis accounting, on the other hand, gives us much more information about what's going on. We can see that SampleCo is making a steady, regular number of sales each month, which implies a degree of stability in their business. We also get a fuller view of Q1 sales. Because not all of SampleCo's customers had paid by the end of March, the cash chart only reflected 60% of the company's actual sales numbers. The accrual chart shows us that more money is on the way, even if it's not in the bank yet.

The accrual-basis chart also shows us that SampleCo made the software purchase in March - we see $1,500 in expenses. Since the money hasn't actually been paid yet, it's not shown in the cash-basis chart. This means that, if we're relying on cash-basis accounting, there's no way to know from the records that SampleCo is about to spend half the cash it just brought in. With accrual accounting, we see that that expenditure is coming, and we can figure it into SampleCo's available cash. This helps avoid accidentally overestimating (and overcommitting!) available cash resources.

The takeaway: accrual-based accounting helps you better track the health of your business, plan for the future, and avoid bad decisions. It's also required by the IRS after you reach a certain size (and your investors will expect it) - so make things easy for yourself, and use it from the start.

BEST PRACTICE #3

Prompt transaction recording

Whether you're analyzing your business's expenses, itemizing deductions, or collecting evidence to claim a complex tax credit, you'll need detailed information on what your business spent and why. There's an easy way and a hard way to go about this: the hard way is trying to track down receipts and remember details from months earlier. The easy way is to record it when it happens.

It may be simple compared to accounting and bookkeeping methods, but good habits around recording your expenses are just as important. Do a favor to your future self, and get in the practice of proactive record-keeping.

04

Set Up a Sustainable Back Office

Your “back office” is the set of essential functions that allow your business to actually run - payroll, bookkeeping and accounting, HR, legal, and more. While the back office is vital for your company to function, it can also be a handful to manage. Here’s a few of our recommendations for keeping everything under control, while still getting what you need to run a growing business.

TIP #1

Get your books in order

Quality bookkeeping is the bedrock of financial management. If your books aren’t accurate and up to date, how do you really know what’s going in with your finances?

Good books don’t just happen, of course - and when you have a million other priorities, it’s easy for bookkeeping to be one of the things that falls by the wayside. Save yourself future problems by setting up a sustainable bookkeeping process now. This includes figuring out how your books are getting done, since you likely won’t have the bandwidth to do a good job on them yourself. Resist the temptation to leave this until your company is bigger - it will be much easier to get your books in order before they get complicated, rather than waiting until you already have a problem.

TIP #2

Don't DIY your payroll

Besides just getting on-time paychecks to your employees, correctly managing payroll includes complex calculations for tax withholding, insurance, and other considerations. Part of your payroll responsibilities also include ensuring the right tax amounts are sent to the government at the appropriate time. It's easy to make mistakes, and those mistakes can be costly - particularly around taxes, where the IRS starts accruing penalties from the very first day they're overdue.

Payroll is one area where the risk and effort of handling it yourself outweigh any potential cost savings. Instead, get a payroll service like Gusto or Rippling to professionally manage your payroll for you.

TIP #3

Set up an expense reporting tool, before you need it

Do yourself a favor, and set up an expense management system like Expensify from day one.

Whether it's a hotel room for an out-of-state client meeting or team-building happy hour, at some point an employee will make a purchase on behalf of the company and need to be reimbursed. If you don't have a policy around which expenses are reimbursable, what the spending limits are for certain expenses, and what the process is for getting paid out, this can be a mess. It's also an area ripe for improper spending, often by employees who don't realize they're making mistakes.

Save everyone a headache (and potentially some embarrassment) - put together a clear, detailed policy on expensing and reimbursement (and a software system for tracking it), before you need to use it.

TIP #4

Plan for invoicing

If your company is pre-revenue, chances are you aren't sending out invoices just yet. Eventually, however, you'll bring your product to market and start making those sales. When that happens, be ready to avoid common stumbles around customer invoicing. To avoid payment or processing errors, make sure your invoices always include the following:

- **Clear customer details:** Who is the invoice for? Use the entity's legal name.
- **Net terms:** How long does the customer have to pay you? This makes it clear when they actually need to send the check, and helps you project when the money will come in.
- **Service period:** If you have a SaaS product or other subscription service, what time period does the invoice cover? This is important for revenue recognition.

This is another area where it often makes sense to use an invoicing solution rather than trying to DIY. The time savings will allow you to focus on selling more products, rather than invoicing for them.

Our Recommended Financial Stack

We've worked with hundreds of founders on building their business, including their back-end financial stack. Based on our experiences, we recommend these to startups looking for solutions:

Credit card: Brex	**Credit card processing:** Stripe
Payroll: Gusto, Rippling	**Accounting software:** QuickBooks Online
Expense reporting: Expensify	**Bank:** SVB, Mercury, FirstRepublic, Chase
AP/AR: Bill.com	**Bookkeeping, tax preparation, CFO services:** Pilot

How to Read Your Financial Statements

Your financial documents are a vital tool for monitoring your business's health, and gleaning the information you need to make the right decisions. In this section, we'll look at your three primary financial statements, what each of them tells you, and how they work together to give you a full view of your business.

The Balance Sheet

The balance sheet shows your company's assets (what the company owns), your liabilities (what the company owes others), and your equity (the difference between the assets and liabilities). Let's have a look at an example for SampleCo.

Sample balance sheet

Assets	
Current Assets	
Bank Accounts	
1002 Wells Fargo Checking	$ 45,000.00
Total Bank Accounts	**$ 45,000.00**
Other Current Assets	
1200 Credit Card Receivables	$ 50.00
1400 Prepaid Expenses	$ 100.00
Uncategorized Asset	-
Total Other Current Assets	**$ 150.00**
Total Current Assets	**$ 45,150.00**
Fixed Assets	
2400 Office Equipment	$ 2,000.00
2410 Accumulated Depreciation Office Equipment	($ 500.00)
Total 2400 Office Equipment	**$ 1,500.00**
Total Fixed Assets	**$ 1,500.00**
Other Assets	
2500 Organization Expense	$ 1,450.00
2600 Rental Security Deposits	$ 3,000.00
Total Other Assets	**$ 4,450.00**
Total Assets	**$ 51,100.00**

Liabilities & Equity	
Current Liabilities	
Credit Cards	
3000 Capital One CC	$ 6,000.00
Total Credit Cards	**$ 6,000.00**
Other Current Liabilities	
3070 Payroll Liability	-
3200 CA Income Taxes Payable	$ 100.00
Total Other Current Liabilities	**$ 100.00**
Total Current Liabilities	**$ 6,100.00**
Equity	
3700 Opening Balance Equity	$ 10,000.00
3800 Retained Earnings	$ 25,000.00
Net Income	$ 10,000.00
Total Equity	**$ 45,000.00**
Total Liabilities & Equity	**$ 51,100.00**

Let's take a closer look at what's going on.

This section shows the assets - what SampleCo owns. In this example, we see that the company has $45,000 in their bank account. In the Fixed Assets section, we see they own office equipment worth $1,500 after depreciation.

Assets	
Current Assets	
Bank Accounts	
1002 Wells Fargo Checking	$ 45,000.00
Total Bank Accounts	**$ 45,000.00**
Other Current Assets	
1200 Credit Card Receivables	$ 50.00
1400 Prepaid Expenses	$ 100.00
Uncategorized Asset	-
Total Other Current Assets	**$ 150.00**
Total Current Assets	**$ 45,150.00**
Fixed Assets	
2400 Office Equipment	$ 2,000.00
2410 Accumulated Depreciation Office Equipment	($ 500.00)
Total 2400 Office Equipment	**$ 1,500.00**
Total Fixed Assets	**$ 1,500.00**
Other Assets	
2500 Organization Expense	$ 1,450.00
2600 Rental Security Deposits	$ 3,000.00
Total Other Assets	**$ 4,450.00**
Total Assets	**$ 51,100.00**

Liabilities & Equity	
Current Liabilities	
Credit Cards	
3000 Capital One CC	$ 6,000.00
Total Credit Cards	**$ 6,000.00**
Other Current Liabilities	
3070 Payroll Liability	-
3200 CA Income Taxes Payable	$ 100.00
Total Other Current Liabilities	**$ 100.00**
Total Current Liabilities	**$ 6,100.00**
Equity	
3700 Opening Balance Equity	$ 10,000.00
3800 Retained Earnings	$ 25,000.00
Net Income	$ 10,000.00
Total Equity	**$ 45,000.00**
Total Liabilities & Equity	**$ 51,100.00**

The liabilities section displays what the company owes others. Here, we see that they owe $6,000 in credit card charges, and $100 in payroll taxes, for a total of $6,100 in liabilities.

Equity is the money that would be left over if the company sold all of its assets and paid off all of its liabilities. In the first section, we saw that the company's total assets were $51,100. If we subtract $6,100 from $51,100, we get the company's total equity: $45,000. Thus, SampleCo's total liabilities + equity is equal to its total assets (the "balance" part of a balance sheet).

The balance sheet represents a single point in time - for example, the state of your business as of July 31, 2020. Use it to assess if your income is heading in the right direction, and what opportunities your company can currently afford.

The Profit & Loss (P&L) Statement

Also called an income statement, the P&L statement shows your revenue and expenses over time. While the balance sheet might show your business's assets and liabilities on July 31, 2020, the P&L statement might show your income and losses over the entire month, quarter, or year to date.

In the income section, we see that SampleCo made $90,000 in revenue over the period. The Cost of Goods Sold line shows us that it cost $20,000 to develop SampleCo's software. The COGS is subtracted from the revenue to give us SampleCo's gross profit: $70,000.

Income	
Revenue	
4100 Subscription revenue	$ 90,000.00
Total Revenue	**$ 90,000.00**
Cost of Goods Sold	
5400 Software development	$ 20,000.00
Total Cost of Goods Sold	**$ 20,000.00**
Gross Profit	**$ 70,000.00**

Sample Profit & Loss Statement

Income	
Revenue	
4100 Subscription revenue	$ 90,000.00
Total Revenue	**$ 90,000.00**
Cost of Goods Sold	
5400 Software development	$ 20,000.00
Total Cost of Goods Sold	**$ 20,000.00**
Gross Profit	**$ 70,000.00**
Expenses	
6000 Employee related	
6010 Payroll	
6011 Gross Wages	$ 30,000.00
6012 Employer Payroll Taxes	$ 2,000.00
Total 6010 Payroll	$ 32,000.00
6030 Health Insurance	$ 1,500.00
6080 Payroll & Benefits Administration	$ 400.00
Total 6000 Employee Related	**$ 33,900.00**
6100 Sales & Marketing	
6110 Advertising	$ 100.00
6180 Sales	$ 600.00
Total 6100 Sales & Marketing	**$ 700.00**
6200 Facilities	
6210 Rent	$ 10,000.00
Total 6200 Facilities	**$ 10,000.00**
General & Administrative	
8000 Bank Fees	$ 100.00
8100 Business Insurance	$ 150.00
8120 Office Expenses	$ 150.00
Total General & Administrative	**$ 400.00**
IT Expenses	
8200 Computer Hardware & Equipment	$ 400.00
8210 Software & Web Services	$ 5,000.00
Total IT Expenses	**$ 5,400.00**
Total Expenses	**$ 50,400.00**
Net Operating Income	**$ 19,600.00**
Other Expenses	
9200 Taxes	
9210 Federal Income Tax	$ 450.00
9220 CA Franchise Tax	$ 255.75
Total 9200 Taxes	**$ 705.75**
Net Income	**$ 18,894.25**

Expenses	
6000 Employee related	
6010 Payroll	
6011 Gross Wages	$ 30,000.00
6012 Employer Payroll Taxes	$ 2,000.00
Total 6010 Payroll	$ 32,000.00
6030 Health Insurance	$ 1,500.00
6080 Payroll & Benefits Administration	$ 400.00
Total 6000 Employee Related	**$ 33,900.00**
6100 Sales & Marketing	
6110 Advertising	$ 100.00
6180 Sales	$ 600.00
Total 6100 Sales & Marketing	**$ 700.00**
6200 Facilities	
6210 Rent	$ 10,000.00
Total 6200 Facilities	**$ 10,000.00**
General & Administrative	
8000 Bank Fees	$ 100.00
8100 Business Insurance	$ 150.00
8120 Office Expenses	$ 150.00
Total General & Administrative	**$ 400.00**
IT Expenses	
8200 Computer Hardware & Equipment	$ 400.00
8210 Software & Web Services	$ 5,000.00
Total IT Expenses	**$ 5,400.00**
Total Expenses	**$ 50,400.00**
Net Operating Income	**$ 19,600.00**

Here we see what SampleCo actually spent, and where the money went. Like most companies, SampleCo's biggest expense is payroll-related, at $33,900. Rent is also a significant cost, at $10,000. At the bottom, the expenses are added up, for a total of $50,400. This is then subtracted from the gross profit ($70,000), to give us SampleCo's net operating income: $19,600.

Net operating income is the moment of truth: if this number is negative, then the company is burning cash to stay operational, no matter how high revenue is. Since the number here is positive, we can see that SampleCo is profitable.

Finally, we subtract any remaining non-operating expenses (in this case, SampleCo's taxes), to get a net income of $18,894.25 over the period.

Other Expenses	
9200 Taxes	
9210 Federal Income Tax	$ 450.00
9220 CA Franchise Tax	$ 255.75
Total 9200 Taxes	**$ 705.75**
Net Income	**$ 18,894.25**

How to Use It

Since the P&L statement shows you data over time, it's useful for determining your trajectory. Are sales generally climbing, holding steady, or down? What about your expenditures? If you see trends that surprise you, or that aren't heading in the direction you want, you'll know that you need to dig deeper into what's going on.

You can also use the P&L statement to examine which parts of the business are contributing to growth, and which parts might be struggling a bit more. This helps you decide where to invest resources moving forward.

One thing to keep in mind: if you're using accrual-basis accounting (and as we've discussed, you should be), the P&L statement reflects your transactions, rather than what's actually in the bank. Income listed on the P&L statement might include invoices your customers haven't yet paid, and expenses might include bills you haven't paid out. For this reason, you'll want to use it alongside your statement of cash flows.

The Statement of Cash Flows

While the P&L statement shows expected revenue and expenses based on your accrued transactions, the statement of cash flows shows what your business actually has in the bank.

The document covers a period of time (a month, a quarter, etc), and tells you how much cash you had on hand at the beginning and end of that period. It also covers where you got that cash (or where you spent it). The statement of cash flows has three sections, for three sources of money:

Operating activities. This is the money brought in or spent in the normal course of your business. Revenue from sales is included in operating activities, as are the costs of running your business. For managing your business and understanding your day-to-day cash position, this is the most significant section to watch.

It's normal for a startup to have negative cash flow for operating activities, even after you start generating revenue. Keeping an eye on the operating activities in your statement of cash flows helps you track your burn rate. If you find that your company's burn rate is significantly or consistently above your plans, you'll know that you need to figure out what's going on and how to get it back on track.

Investing activities. This is cash related to investments your company makes, often in growth. Note that this section doesn't include money others have put into your business - only money invested by your company. For that reason, this is sometimes also called the capital expenditure section.

Sample cash flow statement

Operating Activities	
Net Income	$19,600
Adjustments to reconcile Net Income to Net Cash provided by operations:	
Credit Card	$2,000
Accrued Expenses	$500
Payroll Liability	$5,000
Reimbursement Liability	$100
Total Adjustments to reconcile Net Income to Net Cash provided by operations:	**$7,600**
Net Cash provided by operating activities	**$27,200**
Investing Activities	
Computers & Equipment	-$1,500
Net Cash provided by investing activities	**-$1,500**
Financing Activities	
Preferred Stock	$5,000
Net Cash provided by financing activities	**$5,000**
Net Cash Increase for Period	**$30,700**
Cash at beginning of period	**$45,000**
Cash at end of period	**$75,700**

Financing activities. This is the section that reflects outside investment in your company. If you raise a funding round or take out a bank loan, that cash will be shown here.

Sample cash flow statement

Operating Activities	
Net Income	$19,600
Adjustments to reconcile Net Income to Net Cash provided by operations:	
Credit Card	$2,000
Accrued Expenses	$500
Payroll Liability	$5,000
Reimbursement Liability	$100
Total Adjustments to reconcile Net Income to Net Cash provided by operations:	**$7,600**
Net Cash provided by operating activities	**$27,200**

The operating activities section starts off with your Net Operating Income number from your P&L statement. We already know from the P&L statement that $19,600 is the amount of money that SampleCo brought in for this period. As we've learned, though, accrual accounting doesn't reflect actual cash balance. So, in this section is all about reconciling what's in the bank with what's in the statement.

In this case, we're seeing money that SampleCo has spent in transactions, but not actually paid out yet. We see that they owe $2,000 on their credit card, $500 for an unnamed expense, $5,000 for payroll, and $100 for reimbursing an employee. While SampleCo will pay all of these eventually, at this moment in time the money for those things is still in their bank account. It's worth noting that this can go the other way, too - if SampleCo has not yet been paid for a sale, it will be shown here that that income isn't available as cash. At the end the adjustments are all added up to show that $27,200 of the cash in SampleCo's bank account comes from operations.

Investing Activities	
Computers & Equipment	-$1,500
Net Cash provided by investing activities	**-$1,500**

Financing Activities	
Preferred Stock	$5,000
Net Cash provided by financing activities	**$5,000**

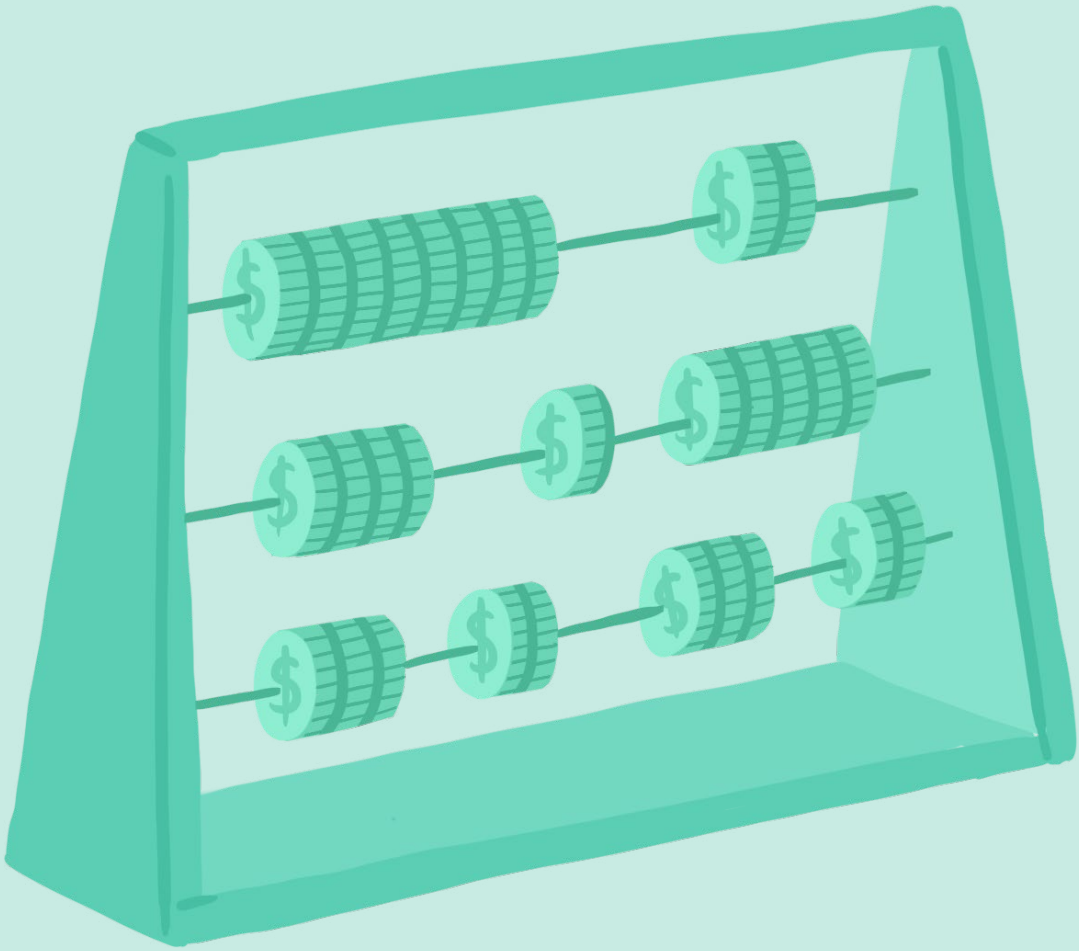
Net Cash Increase for Period	**$30,700**
Cash at beginning of period	**$45,000**
Cash at end of period	**$75,700**

The Investing Activities section shows us that SampleCo spent $1,500 on equipment during this period, and paid out the cash for it.

In the Financing Activities section, we see that SampleCo raised $5,000 in cash by selling preferred stock.

Finally, we get to the total cash changes for the period. Adding up the three totals for operating, investing and financing activities gives us $30,700, the amount of cash that SampleCo brought in during the period. We see here that this substantially increases the amount of cash they have in the bank, up to a grand total of **$75,700.**

The benefits to keeping a close eye on your cash flow are obvious - you want to make sure your burn rate is manageable, and avoid miscalculations that can lead to cash crunches. Additionally, regularly comparing your statement of cash flows to your P&L statement can help you gain insight into how well your business is actually operating. If you have high revenues, but it's not translating into higher cash flow, you'll want to investigate why (for example, maybe you have a collections problem).



How to Set Up a Budget

One of the fundamental tools in managing your business is a thoughtful, well-constructed budget. Besides just the obvious purpose of making sure you don't run out of cash, your budget helps in several ways.

Benefits of a Good Budget

- **Visibility into where you're going.** Besides just where you are today, your budget shows where you expect to be in the future...which means you have to think through how much income you expect to make, how much money you expect to spend, and what you expect to spend it on.

- **Insights that help make decisions.** Your budget should hold the answers to questions like "can we afford a new hire this quarter" and "are we seeing a return on our marketing costs."

- **Tools for course-correction.** Your budget is more than just a collection of numbers; it should be set up so that it's clear where those numbers are coming from. If things aren't going to plan, this helps you determine what actions you can take to get back on track.

Components of a Business Budget

The building blocks of your budget will come from your financial statements, which we looked at in the last chapter.

Revenue. This is your normal income from running your business, i.e. money you make from sales. If you have other sources of income besides sales, these are included in revenue as well.

Cost of Goods Sold (COGS). This is how much it cost to produce the product and/or service you're selling. COGS includes the labor and material costs that go into creating your offerings. It does not include costs that aren't directly related to producing the product; marketing and distribution costs, for example, are not part of COGS.

Gross Profit. This is the profit you make from your sales, before non-COGS expenses are factored in. Gross profit is calculated by subtracting COGS from revenue, and is generally useful for indicating how efficient you are at creating your product.

Operating Expenses (Opex). This is how much you spend to keep your business running. Opex is frequently divided into two subcategories:

Headcount. This is the costs related to paying your employees, and will probably be one of your largest expenses. Besides salaries, headcount costs include payroll taxes, health insurance and benefit fund contributions, PTO, and other benefits that you offer your employees.

Non-Headcount. All operating expenses outside of employee costs fall under non-headcount Opex. This includes rent, utilities, insurance payments, administrative and marketing costs, R&D funding, cost of inventory, and more.

Capital Expenses (Capex). This is how much you spend acquiring assets. Capex purchases are generally investments in assets that will provide the business with future value (as you may recall, "capital expenditure" is another name for the investing activity section of your cash flow statement). Capex applies to both physical items and intellectual property.

A good illustration of the difference between capex and opex is real estate. If you're renting an office, it's opex. You're paying the rent as part of running your business. If you buy an office, however, you're increasing the value of the company's assets and investing in the future - thus, buying an office is capex.

Net income. This is how much money your business is actually making, once all expenses have been subtracted from your revenue. To calculate your net income, first subtract your COGS, opex, and capex from your revenue. Then, subtract any taxes from that number to get your net income amount.

What is a Fractional CFO?

Budgeting is an area that traditionally falls under the CFO, along with other financial strategy elements like forecasting and KPI analysis. An experienced finance leader provides valuable help in growing your business. However, a CFO is usually also an expensive hire - one many early-stage startups can't afford.

A fractional CFO is an outside professional who can give you financial support when you need it, without the cost of a full-time corporate officer. If you want expert guidance in developing your budget and other financial areas, consider engaging a CFO service like the one we offer at Pilot.

A Sample Budget

So how does all this come together in practice? Let's look at a six-month budget for SampleCo.

SampleCo	Q3 2020 Jul 2020	Q3 2020 Aug 2020	Q3 2020 Sep 2020	Q4 2020 Oct 2020	Q4 2020 Nov 2020	Q4 2020 Dec 2020
Ending ARR	100,000	110,000	120,000	130,000	140,000	150,000
Growth %	-	*10%*	*9%*	*8%*	*8%*	*7%*
Revenue	30,000	33,000	36,000	39,000	42,000	45,000
as % of ending ARR	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*
Growth %	-	*10%*	*9%*	*8%*	*8%*	*7%*
Support	15,000	16,500	18,000	19,500	21,000	22,500
Service Delivery	6,000	6,600	7,200	7,800	8,400	9,000
Hosting	600	660	720	780	840	900
Cost of Revenue	21,600	23,760	25,920	28,080	30,240	32,400
Support as a % of revenue	*50%*	*50%*	*50%*	*50%*	*50%*	*50%*
Service Delivery as a % of revenue	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*
Hosting as a % of revenue	*2%*	*2%*	*2%*	*2%*	*2%*	*2%*
Cost of Revenue as a % of revenue	*72%*	*72%*	*72%*	*72%*	*72%*	*72%*
Gross Profit	8,400	9,240	10,080	10,920	11,760	12,600
Gross Margin %	*28%*	*28%*	*28%*	*28%*	*28%*	*28%*
Payroll Operating Expenses	8,333	8,333	8,333	8,333	8,333	16,667
Sales	6,000	6,270	6,498	6,688	6,842	6,964
Marketing	9,000	9,900	10,800	11,700	12,600	13,500
R&D	4,500	4,703	4,874	5,016	5,131	5,223
G&A / Other	3,000	3,135	3,249	3,344	3,421	3,482
Non-Payroll Operating Expenses	22,500	24,008	25,421	26,747	27,994	29,169
Sales Margin %	*20%*	*19%*	*18%*	*17%*	*16%*	*15%*
Marketing Margin %	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*
R&D Margin %	*15%*	*14%*	*14%*	*13%*	*12%*	*12%*
G&A / Other Margin %	*10%*	*10%*	*9%*	*9%*	*8%*	*8%*
Total Non-Payroll Opex Margins	***75%***	***73%***	***71%***	***69%***	***67%***	***65%***
Operating Income / Loss	(22,433)	(23,101)	(23,674)	(24,160)	(24,568)	(33,236)
Operating Margin %	*(75%)*	*(70%)*	*(66%)*	*(62%)*	*(58%)*	*(74%)*
Net Income	(22,433)	(23,101)	(23,674)	(24,160)	(24,568)	(33,236)

Analyzing the budget gives us several insights into SampleCo's business. The budget also shows several areas where SampleCo might have room to improve.

INSIGHTS:	THINGS TO CONSIDER:
They're expecting a slowdown in revenue growth. In August, SampleCo is projecting 10% revenue growth. By December, the projected revenue growth is only 7%.	**The revenue slowdown.** Why is this expected, and is there anything they can do to encourage higher growth?
They're expecting to increase gross profit, while maintaining their margins. By December, SampleCo projects that their gross profit will increase to $12,600, from the $8,400 they started with in July. Margins, however, are projected to stay consistent at 28%.	**COGS.** If SampleCo can lower COGS, they could improve their gross profit. How can they improve efficiency in delivering their product? Is it possible to negotiate lower rates with their suppliers?
They're expecting to improve their operating margins. We see that SampleCo's operating expenses are projected to climb, presumably as they continue to scale. However, revenue is climbing faster - so even though operating costs are higher, they represent a decreasing percentage of revenue. As a result, SampleCo's operating margins are expected to become healthier.	**Marketing efficiency.** SampleCo's biggest operating expense is their marketing. This isn't necessarily a problem, but SampleCo should examine if they're getting an appropriate return on the money they're spending. How much are they paying to acquire customers? Can they sustain that spending? Are there any channels or activities that are high-cost but not delivering results?

Building Your Own

Like the sample we just saw, your own budget should lay out your financial starting place, and where you expect things to go from there. If you're doing this for a new business, it can be a bit daunting - how do you know what to expect?

The truth is, all budgets are just educated guesses. No one can read the future, and even big established companies sometimes guess wrong. What you can do is put careful thought into your estimates, and ensure your projections are rooted in reality.

Here's a few things to keep in mind as you work on your budget.

- **Identify the key drivers of your business.** A critical part of predicting where your business will go is understanding which things affect your outcomes. What has the biggest impact on how your business performs? For revenue, this might be something like website traffic, sales leads, or sales quota attainment. For costs, this could include things like resource usage per customer (for example, AWS bandwidth), internal efficiency, or suppliers.

- **Use your best inputs.** While your projections are ultimately guesses, you can improve their accuracy by making sure your projections are based on the best information you have available. If you have any historical data, use it as a resource. For example, if your margins have been consistent and your cost structure hasn't changed, you can reasonably assume your margin numbers will stay the same. If you've seen a sustained trend in areas like web traffic or conversion rates, you might project that that trend will continue at its current rate.

- **Understand your expected changes.** 12 months from now, your business probably won't look the same as it does today. What are the most significant changes you expect to make? This might include hiring additional staff, or renegotiating key contracts. These should be reflected in your projected budget.

Managing Your Business Taxes

For most people, filing business taxes will be significantly more complicated than filing their personal taxes. There are multiple types of business taxes that your company may be liable for, and they can vary from place to place. It's a good idea to get familiar with what taxes your company will owe and the information you'll need to provide, before it's tax time.

Types of Business Taxes

Corporate income tax. Like your personal income tax, corporate income taxes are paid separately to both the federal government and any applicable state governments. For individuals and C-corporations, the annual due date for corporate income tax is April 15, and for S-corporations and partnerships the due date is March 15. It's important to remember that **even if your business has no income (and thus doesn't owe any income tax), you're still legally required to file.**

Payroll tax. As a business, you're responsible for deducting the right amount of taxes from your employees' paychecks (both for federal and state taxes, and for Social Security, Medicare, etc), and passing that money on to the appropriate governments.

Earlier in this book, we recommended using a payroll service rather than trying to handle this yourself. This is one of the areas where that investment really pays off. Payroll tax withholding is a lot to manage (so much so that some enterprises have headcount dedicated entirely to payroll). Using a professional service takes the burden off you, and lowers your risk for costly mistakes.

Franchise tax. In addition to state income tax, some states also charge a franchise tax. While an income tax is a tax on money you make (and so you won't owe unless you actually make income), a franchise tax is a tax on doing business in the state. Whether or not your business had income for a given year, you'll still need to pay any applicable franchise taxes.

City tax. Depending on where you do business, you may also owe tax to one or more cities. Not all cities levy their own taxes, but for the ones that do, businesses usually owe the tax if they have a "presence" in the city - even if they don't have an office there. In San Francisco, for example, the city business tax applies to any business "operating" in SF, whether or not they have an official office location. Be certain to carefully research the tax rules for any city where they might apply to you.

Gross receipts tax. A gross receipts tax applies to all of a business's income, regardless of the source - sales, rent, licensing, interest, dividends, or anything else. This is different from a sales tax, both because it applies to income besides sales and because it is paid by the business (sales tax is usually paid by the purchaser). Some states and localities use a gross receipts tax as their business tax.

Sales tax. For any goods (and in some states, services) that you sell, you are required to collect any applicable sales tax and pass it on to the state. While this is fairly straightforward if you only sell in a single location (a brick and mortar store, for example), it can quickly get out of hand for ecommerce companies that take orders from around the globe. Every state has different rates and rules for sales tax, and you'll need to make payments for each state that you make a sale in.

> Like payroll, managing sales tax yourself is generally not worth the headache. We recommend using a service like TaxValet or Avalara to help handle this.

Value-Added Tax (VAT). If you sell your products internationally, you'll likely encounter VAT. Essentially a different approach to sales tax, VAT applies taxes at each stage of production based on how much the value of the item increased. For our purposes, however, VAT is not that different from the usual sales tax: you'll need to do the same tracking, collection, and sending of funds to the appropriate government.

Terms to Know

Estimated payment. US state and federal tax filings are due either March or April 15, depending on your company type, and a common misconception is that the year's tax payment is due on the same day. However, this isn't correct.

Rather than a lump sum on tax day, you're required to pay income tax installments throughout the year. If you expect to owe more than $1,000 in income taxes as a sole proprietor, partner or S-corporation shareholder, or if you expect to owe more than $500 as a corporation, you need to make estimated payments quarterly.

Of course, this only applies if you expect to actually owe any income tax. If your business has no income, then you won't have any payments to make.

Automatic extension. The IRS allows businesses to file for an automatic extension for six months, changing the filing deadline to 9/15 for S-corporations and partnerships, and 10/15 for C-corporations. There is no penalty for requesting the extension, and it's standard process for many businesses to get one.

Important to note, however, is that if you do owe income taxes, you'll still need to pay your estimated amount by the original deadline. If your estimate is wrong, you can correct that in your actual filing.

Important Forms

1099. Companies withhold payroll taxes on behalf of their employees, but generally not for contractors; contractors are responsible for making those payments themselves. If you paid any US-based contractors, LLCs or lawyers $600 or more to do work for you, you have to report that payment to the IRS with a 1099-MISC form. You'll also send a copy to your contractors, so they have that information for their tax returns.

W-9. This is the Request for Taxpayer Identification Number and Certification, which you'll send to your contractors in order to get the information you need to file your 1099s. The W9 form itself is just for your own records, and you don't need to send it to the IRS.

As a best practice, we recommend requiring a W9 before issuing any payments to contractors. This lets you avoid a tax-time scramble to track down information for people you paid throughout the year.

W-8 BEN and W-8 BEN-E. The W9 is for US contractors. If you paid any contractor or entities outside the US, you'll need to use W-8 BEN (for individuals) or W-8 BEN-E (for an organization) instead. Like the W9, this is for your own records. You don't send a copy to the IRS.

K-1. If you're filing as a partnership or an S-corporation, you'll need to issue these to your investors and shareholders. Similar to the 1099s you'll send your contractors, the K-1 provides information to the IRS about the income your partners/investors will owe taxes on, and to your partners/investors themselves so that they can file their own taxes. K-1 forms are due to the IRS on 3/15.

Preparing For Business Taxes

When your first tax time comes around, these are the steps to follow as you prepare to file your company's taxes.

TAX PREP TIP #1

Close your books

When you "close your books," you're finalizing your financial records for a certain period of time. In this case, you're closing your books on the previous tax year. Until the close is finished, your fiscal numbers aren't really final - so it's vital to finish this step before you start filing your taxes.

When you close your books, you'll transfer your net income or loss for the year from your profit & loss statement into a permanent entry in your balance sheet, and zero out the P&L sheets so you can start fresh for the new fiscal year. The actual process involves reconfirming your balance sheet items (are your asset and liability balances correct? Have you recorded depreciation against all your assets? Are there any math errors?), recording any previous-year expenses or revenue which haven't been paid or received, and tying up any loose ends for the year (are all your transactions categorized?).

If your books are in good shape, year-end close may only take a few weeks. If you're way behind on your bookkeeping, however, it can be a much larger (and more painful) project. Going back to our advice from the very first chapter - don't let your books get to the place where tax time is a monthslong firefight. Ideally you should be doing frequent updates and monthly closes; if you can't, it's time to bring in help. Don't wait until tax time to catch up on bookkeeping.

TAX PREP TIP #2

Determine what taxes you owe

In the previous section, we saw that there are a wide range of taxes a business might be required to pay, beyond just federal and state income tax. To avoid penalties, be sure to carefully research what your company owes, and to where. Note also that while some taxes only apply to companies with revenue, others apply to every business regardless of income.

TAX PREP TIP #3

File for an extension if you need it

We discussed the automatic extension option in the previous section: any company can apply for an extra six months to file their federal income taxes, so long as they make the request by the original filing date.

If there's any possibility that you will not be ready to file by the standard deadline, it's a good idea to take the extension. There is no negative connotation to doing this, and many companies take it every year as part of their normal tax process. The extra six months will give you time to ensure you can be totally confident in your numbers when you actually do file.

TAX PREP TIP #4

Pay on time

If you take the extension, you have extra time to file your taxes - but if you expect to owe money, you still need to pay by the original date. You'll pay the amount you estimate you'll owe, and if it later turns out you made a mistake, you can either get a refund or pay the difference when you file the full returns.

TAX PREP TIP #5

Alternatively: engage a tax preparer

If your budget allows, dealing with taxes is another area that you might want to leave to a professional. Taxes can be a large distraction from the day-to-day of running your company, and you may be better served offloading them to someone else so that you can focus on your business.

Measuring the Health of Your Business

You already know that data is the bedrock of modern business. Knowing data is important, however, doesn't mean you know the right data to collect and how to use it effectively. If that's where you find yourself, don't sweat: it's actually pretty common for first-time founders to know a lot more about how to build solutions than about how to measure business results.

Where to Start

Now that you're here, you'll want to get up to speed quickly. Familiarity with your business's financial data and what metrics to analyze are important in more ways than one. Good business data is obviously vital for making strategic and budgeting decisions. However, it's also something your investors will be interested in and have questions about - and they won't be impressed if you don't have answers.

In this chapter, we'll go over some common metrics for measuring how your company is doing - which are also metrics your investors will likely use to value your business.

Key Performance Indicators (KPIs)

Your Key Performance Indicators (KPIs) are metrics that lead to your financial results. Every company is unique, and the specific metrics you'll use for your business's KPIs will depend on things like your market, your product type, your industry vertical, and your plans for the business. Regardless of what they are, however, KPIs have one thing in common - they'll measure things that are connected to your business growth.

While KPIs usually include things directly tied to revenue, like number of sales or subscribers, they also include factors that lead to revenue.

A few examples

- **KPIs for a search engine** might include the numbers of searches each day, and how many ads are clicked each day. The ad clicks generate revenue, obviously, and the number of searches indicates the potential audience for ads.

- **KPIs for SaaS businesses** often include customer cost/revenue metrics like CAC and LTV (we'll discuss these in more detail later), as well as churn. Tracking churn helps indicate how satisfied the customer base is with the service, while tracking CAC and LTV help determine if the business model is sustainable.

- **KPIs for an ecommerce business** might include things like average order volume or cart conversion rate. These metrics help indicate whether the retailer is getting ROI on their marketing, and how well the purchase experience is working to move customers forward.

KPIs matter because they measure the things critical to your business's health. If your KPIs are trending in the right direction, it's a sign things are going well. If not, it's a red flag that something may be wrong. If you do have a problem (or just want to see where you might be able to improve), examining your KPIs can help.

Because they track specific things related to revenue, KPIs can be useful in determining where a process is breaking down. Going back to our SaaS example, if a company's sales numbers are good, but their churn is very high, it's a warning sign that many customers aren't seeing value once they start the service. The company may need to invest in more customer success resources, or examine their sales process to determine if they're correctly qualifying prospects.

Determining Your KPIs.

We can't tell you exactly what your KPIs should be - as we discussed above, every company is different. The important thing is that your KPIs reflect revenue drivers for your company.

It's not uncommon for new companies to struggle a bit with what their KPIs should be. To identify your KPIs, you have to first get a strong handle on what actually drives your business. Where will your revenue come from? What has to happen, in order for that revenue to materialize? What can you do to make those things happen?

Customer Cohort Analysis

A cohort analysis examines a group of people who have something in common, over a period of time. In the course of the analysis, you track the group's actions and outcomes.

Examples

- A non-business cohort example is a high school graduating class. This kind of cohort analysis is popular in social studies, where the study might include subsequent college attendance rates, income trends, and career choices. These might then be compared to each other or cohorts from other high schools.

- A more business-oriented example is a group of customers who made their first purchase at the same time. Characteristics like their average purchase amounts, number of repeat purchases, or churn could be compared to other cohorts to track trends among customers.

Customer cohort analysis matters because it offers a good indicator of product-market fit and customer experience. If your cohorts are consistently showing renewal or repeat-purchase rates, that's a good sign that your product fits your customers' needs and offers the right value. If you see significant shifts between your cohorts, you'll want to investigate what's causing it.

Determining Your Cohorts.
Your cohorts should be based on a common attribute that makes sense for your business. Besides the example we mentioned about purchase dates, you might consider cohorts based on attributes like channel (do different channels deliver different types of customers?), or geographic location (based on cohort spending, is there a geography where it makes sense to increase your advertising?).

The same thing goes for analyzing your cohort groups - choose metrics that tell you what your business needs to know. SaaS companies, for example, often track things like ARR, net churn, and gross churn. In ecommerce, commonly tracked metrics include return rates, repeat purchase rates, and basket size over time.

Customer Acquisition Cost (CAC)

Your Customer Acquisition Cost (CAC) measures how much your company pays to gain an average customer. CAC typically includes advertising costs, sales commissions, referral fees, and other marketing expenses.

Examples

- A new apparel brand spends $3,000 on advertising to promote its clothing line. That quarter, 500 people buy its products. The apparel brand's CAC for that quarter is $6 (3,000 divided by 500 = 6).

- A B2B mobile platform company spends $10,000 on a marketing campaign, and closes deals with 8 customers. Additionally, the company paid its salespeople a $1,000 commission for each closed deal. The mobile platform company's CAC for that period is $2,250 (10,000 + 8,000, divided by 8 = 2,250).

CAC matters for ensuring that your company is growing sustainably.

Big increases in customer or user numbers look good on a graph; if those customers aren't bringing in enough revenue to cover their acquisition costs, however, then you have a problem. For this reason, CAC is usually used alongside LTV (which we'll cover next).

Customer Lifetime Value (LTV)

Lifetime Value (LTV) measures the amount of gross profit you get from a customer over the course of your business relationship.

Examples

- A streaming service sells subscriptions for $120 per year. Providing the service costs $30 per year, so each subscriber brings $90/year in profit. If someone remains a subscriber for 5 years, their LTV is $450 ($90 profit x 5 years = $450)

- An enterprise software company sells licenses to use its product for $500/seat, and makes $400/seat in gross profit. A startup buys 3 seats the first year, 5 seats the second year, and 4 seats the third year. As a customer, the startup's LTV is $4,800 (3 seats + 5 seats + 4 seats x 400 profit = $4,800)

LTV matters because ultimately, your business will only succeed if your average customer LTV is higher than your overhead. Going back to our examples with CAC - on its own, CAC doesn't tell us how successfully your business is growing.

In CAC example 2, we see that the B2B mobile platform paid $2,250 to acquire the average customer, but without LTV we don't know if that's good or bad. If their customer LTV is $5,000, then things are looking good - they'll make back those marketing costs, and then some. But if their average customer LTV is $1,000, then the company is in trouble. They won't recoup the money they spent acquiring their customers - and in fact the more customers they gain at that CAC rate, the more money they'll lose.

When your business is starting out, it's not uncommon for your first customers to have an unfavorable CAC/LTV ratio. As you begin to get established in your market, however, those ratios should start to shift. If your CAC is consistently higher than your LTV, you'll need to look for ways to increase efficiency in your marketing and growth channels.

Benchmarking

You're probably already familiar with benchmarking - measuring something against its peers or competitors to judge performance. When it comes to your business, you'll benchmark your company against other companies of similar size and market position.

You may not have peers or competitors who are an exact fit for your company's situation, particularly if you're at the forefront of a new product category.

The important thing is to get as close as you can to an apples-to-apples comparison, even if it means benchmarking to companies in different niches than yours.

Examples

• A startup offering enterprise software might want to benchmark against other B2B software companies of comparable size and years in business, regardless of differences in product offering.

• An ecommerce brand might want to benchmark against other similarly-sized brands who target the same audience in their space (apparel, home goods, etc).

Benchmarking matters because it gives you a frame of reference for your metrics. New founders sometimes struggle with not knowing what to make of the numbers they have - is your CAC reasonable for a company at your stage? What about your burn rate? What's "normal," and what's a red flag? Benchmarking can help give some clues.

Determining your benchmarks.
Your best bet here is to locate tools to help. For SaaS companies, this online data tool by OpenView partners is a good place to start.

Closing

There's a lot that goes into running a successful business, besides just a great vision. While managing the financial side can be undeniably complex, making the right choices early on helps set up your company to scale as your business grows. It's worth the extra effort now to create greater success later on

And one more thing to remember: you never have to do it alone. Whether it's us at Pilot or a dedicated finance hire, bringing in experts to help lets you focus on why you're here in the first place: building the next big thing in tech.