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Budgeting and Financial Statements for Startups

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In addition to the hundreds other things you must think about when starting your business (e.g., facilities, equipment, personnel, permits and sales), you must consider a financial plan (budget) for the business and a way to measure financial performance (financial statements) against the budget on a periodic basis. Once your company has been financed through either debt or equity, you can expect that your investors will require (1) an annual, board-approved budget, (2) quarterly (or more frequent) statements showing a comparison of the budget to actual results and (3) quarterly (or more frequent) financial statements based on generally accepted accounting principles (GAAP). You can also expect a requirement that your annual financial statements be audited by an independent certified public accounting firm.

BUDGETING – A THREE-STEP PROCESS

1) Develop goals – The most effective budget is one that starts with the corporate goals of your organization, and your budget is a tool to understand the financial consequences of your operational plan. The corporate goals of organizations will vary greatly among industries and may include sales goals (for manufacturing and distribution companies), billable hours (for professional service providers) and scientific goals (for biotechnology companies). Goals should be developed by the management team and/or CEO and be focused on creating value for your shareholders.

2) Determine resources, make estimates and assumptions – Significant thought is necessary to plan what resources are necessary to reach your goals. For example, a new product launch requires assumptions and estimates around pricing, units sold, cost of goods sold, additional marketing costs, sales force requirements and more. If your corporate goals involve research and development of new products, it is important to consider head count, equipment and facility needs. Other considerations may include a public offering of your equity, which requires estimates and assumptions around legal costs, auditor fees, printing fees and more. When developing estimates for these items, don't be shy about reaching out to your network to get these estimates.

3) Compile the results – The last part of the budgeting exercise is to compile the results from steps 1 and 2 and produce, in Excel, an operating budget and a capital budget. The compilation will provide a financial picture for your organization based on the goals for the coming year. The complexity or simplicity of this compilation will depend on the complexity or simplicity of your operations. Your operating budget should include logical cost centers that will correspond, at some level, to your organizational chart. The exhibit is a hypothetical example of this compilation.

Expect the budgeting process to be iterative – you will likely need to revisit these three steps several times prior to submitting the documents to your board of directors for approval.

FINANCIAL STATEMENT PREPARATION

Financial statements, the basics – Four financial statements are outlined under GAAP: a balance sheet, statement of operations, statement of cash flows and statement of changes in stockholders' equity. Plus, a set of footnotes accompany the financial statements. You can get an idea of what is included in a set of financial statements by looking at any public company's Securities and Exchange Commission (SEC) filings through EDGAR on www.sec.gov. The balance sheet is as of a point in time and outlines the company's assets, liabilities and stockholders' equity. The three other statements (operations, cash flow and changes in stockholders' equity) are for a period of time, typically a three-month period and a 12-month period.

Under GAAP, financial statements are required to be prepared on an accrual basis and not a cash basis, which requires a bit of training. In general, expenses are recorded when incurred, not paid, and revenue is recognized when earned, not received. GAAP also requires the capitalization of fixed assets (e.g., equipment, buildings and so on) and requires that they be depreciated over their useful life. If you do these three things – (1) record revenue when earned, (2) record expenses when incurred and (3) capitalize and depreciate fixed assets – you are on your way to producing GAAP financial statements for your investors.

Financial statements, the complex – GAAP requires other items that are best left to certified public accountants (CPAs), including accounting for stock-based compensation, income taxes and derivative financial instruments (e.g., warrants, puts rights, call rights and so on), which may be embedded into your financing documents. You should strive to get agreement with your investors that these items will be reflected not in your quarterly statements but rather in your annual statements. Likewise, you should plan to provide footnotes to the financial statements on an annual basis, not a quarterly basis. These actions will save you significant time and expense while still allowing your investors to adequately track your financial performance.

Budget to actual – Once you have finished your financial statements, you can make a comparison to your operating budget and capital budget. You should share these results with your board of directors at your regularly scheduled meetings. The exhibit includes an example of a hypothetical budget to actual.

Accounting and budgeting software – Several types of accounting and budgeting software are available, all with different levels of complexity. QuickBooks should meet your needs as a startup, as it has the ability to assist with bill payment, invoicing, fixed asset tracking and preparation of financial statements. Once an organization becomes more complex, with decentralized operations, it may be time to turn to more sophisticated material requirements planning (MRP) software packages, but a discussion of these packages is outside of the scope of this article.

About the Author

Sean Cassidy is the chief financial officer of Arvinas, a biopharmaceutical company located in New Haven, Connecticut. He was previously chief financial officer or controller of three other Connecticut-based bioscience companies. Sean is a CPA and spent over nine years in the audit practice at Deloitte in the Hartford office. You can contact him at sean.cassidy@arvinas.com.