Part 1: Why bother with the numbers

A well executed financial strategy steers businesses towards healthy growth. Financial strategy should include financial controls that keep operations in check, as well as financial optimisation that best leverages capital to achieve growth - this principle applies not only to personal finance and startups but also to big corporations and governments. A business is inherently profit-seeking which differs from a hobby or interest and hence the reason for the dichotomy between many great ideas and few successful businesses.
Success can be defined as staying in the game; roughly 80% of small businesses survive their first year, about half survive five years or longer, and only about one in three get to the 10-year mark and live to tell the tale[1]. The odds of survival seem discouraging but, luckily for the new and experienced entrepreneurs, we can access, thanks to todays' speed of news and digital media, daily references on why startups (seem to) fail. Similar to having a healthy diet with grass-fed produce, healthy financials are paramount in helping to fuel organic business growth. When your diet goes wrong, you become sick; when your financials do not work out, have been ill-prepared or overly boosted, your business may file for chapter 11, also known as "you are officially out of business".
According to the 2019 CBinsights, running out of cash is the top #2 reason why startups fail[2]. The ability to either generate self-sustaining cash flow or to raise funding is critical to the survival of startups - you don't need to, as a pre-requisite to launch any business, know finance & accounting to become an entrepreneur but mastering your business financials will surely help improving your odds of being a successful business founder. Why?

1) Developing a financial forecast helps entrepreneurs rationalise assumptions and validate business model early on from a numeric and objective perspective. Most, if not all, entrepreneurs have optimistic personalities. When converting business assumptions into quantifiable terms, the tendency is to overshoot future sales and underestimate costs in a variety of ways.

Projecting revenue
Projecting sales from an untested customer base is more difficult than that from a stable one based on a mature product. Sales growth projection requires you to analyse market depth for your potential product or service, define client segmentation and estimate wallet share. However, market conditions, customer behaviours, competitive products and other external factors can skew the original projection by a large degree. You would then need to revisit this projection exercise on a periodic basis, which will help you identify deviations from your assumptions and adjust business models if and when required. Factors that should be incorporated into your considerations should include:

- How many revenue sources do you have and what is your revenue model?
- What is your projected sales growth rate and how it relates to your go-to market strategy?
- Do you have a sizeable total addressable market ("TAM"), which usually sets an upper limit on your revenue potential?
- What are the revenue recognition criteria applicable to your business as not all the sales (you think you have made) can be recognised as revenue in accounting terms?

Projecting expenses
The expenses side of the profitability equation can be internally controlled. While exact cost structures may vary by industry, you should be able to develop detailed estimates and conduct ongoing scrutiny of four categories of cost items that are common to any business - cost of revenue, research and development ("R&D"), marketing and general & administrative expenses. Even if you consider yourself as a product or engineering type of entrepreneur without any financial knowledge, you can still potentially estimate the

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[1] U.S. Small Business Administration Office of Advocacy, "Frequently Asked Questions about Small Business", August 2018, https://www.sba.gov/sites/default/files/advocacy/Frequently-Asked-Questions-Small-Business-2018.pdf (August 15, 2020 access)

[2] CB Insights, "The Top 20 Reasons Startups Fail", November 6, 2019 https://www.cbinsights.com/research/startup-failure-reasons-top/ (August 1, 2020 access)

cost of your newly designed products as you move along the technology innovation S-curve[3] - for example, if you are heading a startup manufacturing electric vehicles you can derive the estimated cost of revenue by referring to the various cost inputs - in the example of lithium ion batteries as a power source, this cost input has fallen 85% since 2010[4].
If substantial amount of startups' initial capital is deployed into R&D to produce a minimum viable product ("MVP"), how should you present for this R&D cost in your financial statements? The decision to deduct your R&D costs as an expense or capitalise it as an asset will be dictated by the accounting standard adopted and can impact your tax position and cash flows. Another potential big spend for startups is marketing or cost to convince a potential customer to buy your specific product or service: how do you budget your marketing expenses based on your target marketing channels and what is your customer acquisition cost ("CAC")? How can you estimate the above expense categories in relation to sales? After accounting for all the expenses, what is your profit margin like "today" versus what it may be once your business reaches scale?

Managing Runway
The distance between your current cash balance on hand and zero is your runway, which can be measured in months or even days. To calculate your runway, you need to know your monthly recurring revenue (your "MRR") and how much cash will you be burning each month (your "burn rate"). Monitoring your runway before you run out of cash may save your business from startup sin number two (sin number one being "not solving a market problem").

Financial forecasting as a control mechanism
Developing a financial forecast of your business is a type of control mechanism that can bring an entrepreneur back on course. During the extravagant spending era of Amazon, CEO Jeff Bezos had "an aha moment" after "his chief accounting officer showed him a form of financial analysis called common-sizing the income statement…. The calculation showed that at its current rate, Amazon wouldn't become profitable for decades. Bezos agreed to lift his foot from the accelerator and begin to move the company towards profitability"[5].

2) Understanding capital management enables entrepreneurs to make prudent business decisions. There is a three-legged capital stool upon which your business is built - working capital, equity capital and debt capital. While you are focused on creating revenue generating assets, you cannot lose sight of the supporting capital foundation.

The risk of not knowing
Do you know what you own and what you owe at any given time? The risk of not knowing can put a toll on even the most well respected entrepreneurs. The self-made film producer, talent manager and actor Jerry Weintraub recalled one of his business failures. "We carried a great mountain of debt before the first writer was contracted or the first scene was filmed. If I had known what to look for, I would have seen it in the early balance sheets - money going out (left pocket) versus money coming in (right pocket) - a terrible premonition…with each flop, debt accrues and pressure grows."[6] The company (Weintraub Entertainment Group) existed for less than four years. You can only grow as far as your capital base allows - It is, therefore,

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[3] IdeaScale, "The S-Curve and Your Innovation Strategy", May 10, 2018 https://medium.com/@ideascalenation/the-s-curve-and-your-innovation-strategy-cf87cf2eca63 (September 22, 2020 access)

[4] Katie Brigham, CNBC, MAR 14 2020, "These new battery technologies could be the future of energy storage" https://www.cnbc.com/2020/03/13/lithium-ion-batteries-heres-whats-coming-to-replace-them.html (September 22, 2020 access)

[5] Brad Stone, "The Everything Store - Jeff Bezos and the Age of Amazon", published by Back Bay Books Little, Brown and Company, copy right © 2013 by Brad Stone

[6] Jerry Weintraub with Rich Cohen, "When I Stop Talking, You'll Know I'm Dead: useful stories from a persuasive man", published by Hachette Book Group, First Trade edition: March 2011, ISBN 978-0-446-54815-1, Copyright © 2010 by Jerry Weintraub

essential to develop good capital management skills so that you can take on business risks while mitigating financial risks.

Hidden secret of cash cows

A cash cow business is defined as "a venture that generates a steady return of profits that far exceed the outlay of cash required to acquire or start it"[7]. How do successful businesses leverage their three-legged stool and deploy different financing options? What is the hidden secret behind Amazon's cash cow business? Thanks to the payment terms it negotiated with suppliers and customers, Amazon was able to generate consistent positive cash flows. Its highly efficient working capital model enabled it to fund its operations and achieve organic growth. For your startup, have you created a schedule of all your expected cash payment due dates and considered how you can optimise your cash cycle?

A balance-sheet dashboard tool

Entrepreneurs need an analysis tool to help monitoring capital. The balance sheet is a dashboard that displays all your assets, liabilities and equity. Beyond financial capital, it also includes value in term of "intangible assets". Disrupters in the New Economy[8] create value from technology, content, customers, etc. If you also use them (intellectual properties) as competitive advantage, would you be able to recognise them as assets? Yes and…no.

Another often over-looked asset that entrepreneurs should be keenly keeping track of is deferred tax assets. Operating losses you may experience in earlier years of your venture may be, based on your tax jurisdiction, carried forward to offset future profits, creating a tax benefit today and cumulating as a cookie-jar reserve. Partly leveraging its tax credit carryforwards and tapping into this cookie-jar reserve[9], Amazon paid zero in US federal taxes in 2018 on a US$11 billion pretax income. Have you looked into similar incentives available in your tax jurisdiction?

3) Knowing how to value a business will set the course for an entrepreneur's fundraising journey. You can only bootstrap so far and will likely require external funding to scale up the business. Choosing the right investors would bring not only financial capital but also business networks and industry expertise.

Serve your investors as customers

Jeff Cavins, CEO of a peer-to-peer RV rental platform Outdoorsy, reflected that communicating to your investors is as important as communicating to your customers. Both stakeholders demand constant information, attention and feedback, the former in terms of product enhancement, the latter regarding financial returns. To serve your "investor" customer base, the ability to articulate in the language they understand requires an entrepreneur to translate their business model into financial terms.

"When you have an idea for a company, you want to go as far as you can without raising money because you want to focus maniacally on customers. It's hard to do because you have to survive, buy food and pay your rent. But the minute you take a nickel from an investor, you now have a new customer that you are beholden to. As the founder, one of your chief customers is your investor; you have to communicate with them constantly. You have to give them the good news and the bad news — they need to hear it all. Be prepared to understand that an investor is your customer as well[10]".

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[7] wikipedia, https://en.wikipedia.org/wiki/Cash_cow

[8] Time magazine, "The New Economy", May 30, 1983, http://content.time.com/time/covers/0,16641,19830530,00.html (September 19, 2020 access)

[9] Amazon riled up the left for not paying federal taxes — and it's in a position to offset future profits, too

[10] Candice Georgiadis, Medium, "Jeff Cavins of Outdoorsy: They told me it was impossible and I did it anyway" April 28, 2020, https://medium.com/authority-magazine/jeff-cavins-of-outdoorsy-they-told-me-it-was-impossible-and-i-did-it-anyway-57750124de55

Prepare your numbers
Before pitching to accelerators, angel investors or venture capital firms ("VC") for funding, have you determined the exact amount of financing you are asking and the cost of doing so? Do you understand their considerations in investing into your business and betting on you as a founder? What type of returns is usually expected from a VC? Are you prepared to give away a percentage of your ownership stake in return for your a certain amount of capital - in the example of Y Combinator[11], an accelerator, to receive US$125,000 you would give away 7% of equity. In the eventuality of your company becomes an acquisition target, how do you judge the fairness of an offer price without knowing how much your business could be worth? Mark Zuckerberg rejected a US$1 billion offer from Yahoo to acquire Facebook because he figured the company would be worth way more than US$1 billion[12].

What's your business price tag?
Before negotiating with investors in different stages of your funding cycle, you need to know how to put a price tag on your business, perhaps even with a sign of "not for sale" ready. There are many ways to value a business… but how do you value a startup? From a real estate investor's perspective, one way to evaluate a property's value is based on cash flows derived from rental income. Using the same intrinsic value approach, a business can also be valued based on future cash flows derived from its business profit. But how can a startup, like Instagram, with no revenue or cash flow be worth US$1 billion? Another approach to assessing a property valuation is to compare prices of properties that share similar layout, conditions, location and neighbourhood. To evaluate your startup, you may be able to find other companies that share similar metrics as your business. So what are some of the key metrics, either financial or non-financial in nature, that entrepreneurs should be aware of and potentially use for their valuation estimate? What other factors can indirectly influence your valuation?

Setting yourself up towards financial success
In the beginning of your entrepreneurial journey, learning to be lean and self-sufficient is vital. Every entrepreneur has personal strengths and limitations, and you may not have business partners or resources to help you in every aspect of the business.

"The biggest mistake founders make is only working on the areas that they're good at, while neglecting the important areas of the business that they're not so good at. Spending time on those neglected areas is important and what ultimately creates successful founders and great companies"[13].

You need to develop both business acumen and financial savvy-ness. Financial fluency will enhance an entrepreneur's overall credibility and skillset. Your credibility in your startup ecosystem will be tracked, and this track record will differentiate you from the competition and attract capital to your business in the future. The purpose of this book is to help unravel the financial reality of your business from the perspectives of your stakeholders - auditors, bankers, investors and other enablers.
I have had the opportunity to witness the success of many aspiring entrepreneurs transitioning from a simple idea in an academic setting into incorporating a company in the real business world. Many struggled with understanding accounting rules, making financial forecast as well as determining initial capital required to launch their business. The old paradigm of classroom memorisation no longer serves as a shortcut to successful implementation. This book also aims to de-mystify important accounting principles and financial models so that you can convey your business not only from a problem-solution perspective but also in numbers.

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[11] Kirsty Nathoo, "The Y Combinator Deal", June, 2020 https://www.ycombinator.com/deal/

[12] Mike Hoefflinger, Business Insider, "Inside Mark Zuckerberg's controversial decision to turn down Yahoo's $1 billion early offer to buy Facebook", Apr 17, 2017 https://www.businessinsider.com/why-mark-zuckerberg-turned-down-yahoos-1-billion-offer-to-buy-facebook-in-2006-2017-4 (September 20, 2020 access)

[13] The Full Ratchet, Podcast Episode 203, "Raising Fund III, A Framework to De-risk Your Startup, & When to Explore vs. Exploit (Leo Polovets)" https://fullratchet.net/203-raising-fund-iii-a-framework-to-de-risk-your-startup-when-to-explore-vs-exploit-leo-polovets/ (October 2, 2020 access)