NEF Guidelines

Software Company Financials

Current NEF Guidelines use Generally Accepted Accounting Principles (GAAP) as the basis for presenting Financials. For Software Companies, which have extremely low Cost of Goods Sold (limited to packaging, direct sales commissions, and direct incremental processing costs), this can result in apparent gross margins frequently in excess of 80-90% of Revenue. This is not only misleading, it presents a picture to investors with very low credibility. Even worse, this presentation does not properly reflect the impact of the most critical software activities – Systems Development, Marketing, and Selling.

Therefore, NEF has worked with software companies it has coached to develop an alternative presentation of Financials that better represents the nature of the company to investors. The following two examples compare Existing Guidelines with a proposed New Format.

The first example shows the results of a software start-up that used the proposed New Format, compared back against a restructuring of the New Format back to the Existing Guideline for comparison:

EXAMPLE 1: CURRENT FORMAT - Reconstructed to Represent Current Format

	Financial Projections					
	FY2014	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**
Revenue	**$0**	**$500,000**	**$6,000,000**	**$16,000,000**	**$32,000,000**	**$65,000,000**
COGS	$0	$20,880	$217,500	$1,740,000	$3,262,500	$5,437,500
Gross Margin	$0	$479,120	$5,782,500	$14,260,000	$28,737,500	$59,562,500
[GM % - shown for illustration purposes only]		96%	96%	89%	90%	92%
Selling Costs	$0	$150,000	$1,800,000	$4,800,000	$9,600,000	$19,500,000
Marketing	$0	$50,000	$600,000	$1,600,000	$3,200,000	$6,500,000
Systems Development	$11,250	$200,000	$1,998,588	$3,997,175	$5,710,250	$8,157,500
G & A	$25,000	$120,000	$200,000	$275,000	$450,000	$540,000
EBITA	($36,250)	($40,880)	$1,183,912	$3,587,825	$9,777,250	$24,865,000
[EBITA % - shown for illustration purposes only		-8%	20%	22%	31%	38%

EXAMPLE 1: NEW FORMAT - As Actually Presented

	Financial Projections					
	FY2014	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**
Revenue	**$0**	**$500,000**	**$6,000,000**	**$16,000,000**	**$32,000,000**	**$65,000,000**
COGS	$0	$20,880	$217,500	$1,740,000	$3,262,500	$5,437,500
Selling Costs	$0	$150,000	$1,800,000	$4,800,000	$9,600,000	$19,500,000
Marketing	$0	$50,000	$600,000	$1,600,000	$3,200,000	$6,500,000
Systems Development	$11,250	$200,000	$1,998,588	$3,997,175	$5,710,250	$8,157,500
Operating Margin	($11,250)	$79,120	$1,383,912	$3,862,825	$10,227,250	$25,405,000
[OM % - not actually shown]		16%	23%	24%	32%	39%
G & A	$25,000	$120,000	$200,000	$275,000	$450,000	$540,000
EBITA	($36,250)	($40,880)	$1,183,912	$3,587,825	$9,777,250	$24,865,000
[EBITA % - not actually shown]		-8%	20%	22%	31%	38%

As can be seen, the Existing Format shows Gross Margins in the un-credible 90-95% range, while the New Format moves Selling, Marketing, and Systems Development 'above the line' and shows an Operating Margin in a more credible 16-40% range. How investment dollars will be spent and how Operating Margins grow make better sense and are easier to understand as related to business plans.

The second example shows a software start-up that used the Existing Guideline, compared back against an attempt to restructure the example into the New Format:

EXAMPLE 2: CURRENT FORMAT - As Actually Presented					
5-Year Pro-Forma			seeking $500K Q4 2014 (convertible debt)		
($000)	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**
GROSS REVENUE	$275	$2,025	$5,650	$26,250	$70,350
COST OF GOODS	390	525	1,500	3,150	5,650
GROSS MARGIN	(115)	1,500	4,150	23,100	64,700
[GM % - not actually shown]		74%	73%	88%	92%
OPERATING EXPENSES	835	1,150	2,250	10,450	17,775
EBITA	($950)	$350	$1,900	$12,650	$46,925
[EBITA % - not actually shown]		17%	34%	48%	67%

EXAMPLE 2: NEW FORMAT - Reconstructed Based Upon Planning Assumptions					
5-Year Pro-Forma			seeking $500K Q4 2014 (convertible debt)		
($000)	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**
GROSS REVENUE	$275	$2,025	$5,650	$26,250	$70,350
COST OF GOODS	390	525	1,500	3,150	5,650
SALES & MARKETING	50	365	1,017	4,725	12,663
SYSTEMS DEVELOPMENT	11	81	226	1,050	2,814
OPERATING MARGIN	(176)	1,055	2,907	17,325	49,223
[OM % - shown for illustration purposes only]		52%	51%	66%	70%
OPERATING EXPENSES	775	705	1,007	4,675	2,298
EBITA	($950)	$350	$1,900	$12,650	$46,925
[EBITA % - shown for illustration purposes only]		17%	34%	48%	67%
Assumes:					
Sales & Marketing @	18%	of Gross Revenue			
Systems Development @	4%	of Gross Revenue			
Operating Expenses = Remaining after Selling, Marketing, and Systems Development					
Note: Operating Expenses no longer make sense when detailed expenses are broken out - this a good example of how breaking out details can help point out weaknesses in plans/financials.					

As can be seen, the Gross Margin using Existing Guidelines is in the 75-90% range, while the New Format shows Operating Margins in the 50-70% range. Note that, because the Existing Guideline format did not even break out Selling, Marketing, and Systems Development, there was very little basis for asking questions related to plans. In fact, when these costs are estimated as a percent of revenue, potential issues (such as how Operating Expenses can drop from $4,675K to $2,296K from 2018 to 2019) begin to arise. And an Operating Margin as high as is shown in the New Format may raise additional questions regarding whether plans have adequately covered expected costs.

Conclusion: The New Format provides a better and more credible picture of a software start-up to potential investors. The relationship of plans to expenses is clearer, and Operation Margin better represents money available to cover other costs than does the Existing Guideline.

Recommendation: Adopt the New Format as the NEF Guideline for presenting software start-up Financials. Here is a summary of the New Format, also including the suggestion to enter business plan Unit Volumes that help provide an even stronger basis for understanding projections:

RECOMMENDED SOFTWARE COMPANY PROJECTIONS FORMAT

	Financial Projections				
	FY1	**FY2**	**FY3**	**FY4**	**FY5**
No. of Units 1	**0**	**0**	**0**	**0**	**0**
No. of Units 2	**0**	**0**	**0**	**0**	**0**
Revenue	**$0**	**$0**	**$0**	**$0**	**$0**
Cost of Goods Sold	$0	$0	$0	$0	$0
Sales & Marketing	$0	$0	$0	$0	$0
Systems Development	$0	$0	$0	$0	$0
Operating Margin	**$0**	**$0**	**$0**	**$0**	**$0**
[OM % - Optional]	0%	0%	0%	0%	0%
General & Administration	$0	$0	$0	$0	$0
EBITDA	**$0**	**$0**	**$0**	**$0**	**$0**
[EBITDA % - Optional]	0%	0%	0%	0%	0%

Also note that, even though this discussion applies specifically to Software Companies, this same format may also provide an improved format for other types of start-ups as well.