Navigating the obstacles of financial projections for start-ups

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Abstract

Being an entrepreneur can be a tough and rewarding experience at the same time. It is a long journey and in order to succeed it requires perseverance, patience, and willingness to deal with unexpected events. There are many challenges that a company, and especially a start-up can face and one of the most important ones is related to financial projections. Start-ups may face many obstacles while working on financial projections that may lead to false projections. Financial projections are a key factor that different stakeholders use to decide whether or not to get involved in the company. The aim of this paper is to make an analysis of the financial projections process of start-ups, to find some of the main issues that they face. This is explorative and interpretative research and is mainly based on secondary information. It is mainly based on a descriptive analysis. According to the findings some of the key issues that start-ups face regarding financial projections are: overestimation of sales; underestimation of costs; difficulties in considering all the risks that can impact the financials of the company; and difficulties in calculating the burn rate and break-even point. These factors were reflected in the way the company is seen by different stakeholders, such as potential investors. This reflects the importance of having accurate financial projections since it is one of the factors that can determine the future of the company. We aim for these findings to serve as a guideline for start-ups to obtain more accurate financial projections.

Keywords: cash flow, expenses, financial projections, revenue

1. Introduction

Finance is one of the key functions in a company, and for young companies the importance of it becomes even more evident. Poor financial management is one of the key reasons for start-up failure, and how good they are at managing their finances can determine their success or failure. One of the key financial challenges related to financial management is making accurate financial projections. There are many factors that make it difficult to have accurate financial projections for all companies and for start-ups it can be even more difficult because they usually do not have any history on which to base financial projections.

"Financial projections are often overlooked by start-ups as a necessity, but they're an incredibly important part of any start-up. Due to the all-important need for cash control, and effective budgeting and planning, financial projections help start-ups stay ahead of what the future might bring." - The Start-up Lab

These words taken from Start-up Lab show the importance of financial projections for start-ups. Unfortunately, many start-ups see them as a necessity, instead of something important. Since financial projections are related to the future, they play a significant role because they help the company get prepared for what the future may bring. Besides this financial projections are one of the key information that need to be included in the pitch deck and a key information that needs to be presented to potential investors. The decision of potential investors whether to invest or not in the company takes into consideration several important factors and financial projections are one of them.

Start-ups may seek funding from different sources which may differ, but each one of the potential investors wants to see how the financial situation of the company is projected to be (FasterCapital, 2023). They need it to see how much money will get back from investing in the company and see if the projected rate of return is acceptable for them otherwise they will not be willing to invest. If financial projections are missing on a pitch deck or are not credible, the efforts of the founders to convince investors to provide them with funding will fail. None would take the risk to invest money in a company without getting back anything.

The high failure rates of start-ups reflect, among other things, also the fact that they are high-risk investing alternatives. This risk perception for start-ups can make it more difficult for them to secure funding, and they shall try to have a perfect pitch deck to convince investors in providing them with funding. Financial projections, as a significant part of the pitch deck, shall be as credible as possible, but is it easy to create accurate financial projections? What are some key obstacles that start-ups face while trying to work on them? What are some of the most common mistakes that start-ups do with their financial projections?

It can be difficult to be accurate on all the variables about which start-ups are making assumptions needed to complete financial projections (Financial Model Net). These assumptions are some of the critical factors that determine the quality and credibility of financial projections. It can be difficult for the company to be as much real as possible regarding its financial projections, and the lack of historical data for start-ups that can serve as a basis for projecting the future makes this process more difficult. Since financial projections need to be based on assumptions and there is not a reliable basis of information for doing that, people who are working on it tend to be subjective on the numbers that they project.

The role that financial projections play in securing funding, as a key component of business strategy or the business plan reflects the importance of having accurate and real financial projections. When they are ready it can help the company see where it will be in the coming years and that can help in finding what are the company's weaknesses and strengths, so it can improve those areas in which things are projected to go wrong. It can also help the company in creating different scenarios by changing the assumptions on which projections are based. One of the key obstacles related to the financial projections of start-ups is being over-optimistic, which may be difficult to be changed (Gilmanov, 2020). This paper will be focused on finding some of the key obstacles that start-ups face while trying to work on financial projections and ways to deal with them. It can serve as a document that start-ups that are dealing with the same problem can refer to.

2. Aim of the paper and methods

The aim of this paper is to analyse the key obstacles that start-ups face when creating their financial projections. Financial projections are critical information with a significant impact on the impression that founders leave when pitching to potential investors. At the same time it is important for the decision-making of start-ups because it creates a picture of how the company's future financials will be, and also see things that can be improved. This paper will focus on explaining the importance of financial projections, the obstacles that start-ups face while creating them, and how to deal with these challenges.

The research is mainly based on secondary research and more on qualitative information rather than quantitative one. It is an explorative and interpretative research and is a combination of the information collected from other sources and the author's professional experience, as someone who is involved in a start-up and has faced different obstacles while creating financial projections. This research aims to serve as a guideline for start-ups that are dealing with the same obstacles while creating their financial projections. The objectives of this research paper are listed below:

- To analyse some key obstacles that start-ups face while creating financial projections.
- To find some ways how to overcome financial projections challenges that start-ups face and create accurate financial projections.
- To create a guideline for start-ups that need help in creating their financial projections.

3. Literature Review

Start-ups have attracted the attention of different actors, including here experts in different fields, academics, and researchers. Particularly in the last years, they have been the center of many discussions. Different people have focused on different issues related to start-ups, depending on their position on start-ups and their interests. Financial projections and the way start-ups deal with them, among other issues and challenges, bring up some critical issues for them. If we compare the interest that many finance professionals and academics have had in this issue, we see that it has not been analysed often by academics. There are not many research papers that analyse the obstacles start-ups face while creating their financial projections. The coming sections make a brief description of the results of some existing research papers.

Fatih and Fachrizah (2021) emphasize the vital role that financial projections, combined with digital marketing measurements, play in the expansion strategies of a company.

According to them, there is a significant positive relationship between digital marketing activities and financial projections. Their research found that measuring and evaluating marketing strategies can result in increased effectiveness of activities that are related to digital marketing. At the same time, it can have a significant positive impact on improving a company's performance, which serves as the basis for creating financial projections. Since financial projections are represented to potential investors, they can impact the decision of investors.

Sawyer et al (2014) focused on the importance of financial models. The research was focused on the way potential investors or lenders see the company and how financial models are related to that. When potential investors make a decision whether or not to get involved in the company, they will make calculations to see if it is worth it or not. Their calculations include the value of the company they are considering investing in. The information collected from the financial model is needed to make this valuation, which is the basis for the decision-making. Similar to potential investors, lenders also need financial models to obtain the information they need when considering whether or not to lend money to a company.

4. Results and Discussion

This research aims to analyse the obstacles that start-ups face while working on their financial projections. Before discussing these obstacles, there is something that needs to be clarified, about some terms. Are financial projections the same as financial forecasts? How do financial projections stay in comparison to financial modelling?

Financial projections and financial forecasts are not the same (Beaver, 2020). They both are related to the future of the company's financials and both use historical and current data, information about the market or industry trends. But there is a key difference between them. While financial forecasts are based more on events that are likely to happen in the future, financial projections are based on different assumptions that are hypothetical, about which the company is uncertain if they will happen or not. Financial projections are strongly connected to financial modelling. Financial modelling uses financial projections to create different scenarios, by considering different potential values of assumptions.

4.1 Types of Financial Projections and the Importance of Financial projections

There are three types of financial projections (FasterCapital). Even though the purpose of each type is the same, the way in which financial projections are created differs. The first type of financial projections is static financial projections, known as well as historical financial projections. As the name suggests these financial projections use historical data to predict the financials of the company. This method is conservative and is widely used by lenders when evaluating whether or not to lend money to a company. It is worth mentioning that for start-ups can be difficult to use this method because there is no history and the information needed to create financial projections is missing.

Another type is dynamic financial projections, also known as current financial projections. These projections are based on the current financial information of the company and tend to be more optimistic compared to static financial projections. They are mainly used by potential investors to assess the company's growth potential. The third type of financial projections is pro-forma financial projections, known also as forward-looking financial projections. As the name suggests these financial projections are based on the plans of the company, on what it is planned for the future. They are mainly used by venture capitalists when considering whether or not to invest in them.

Till here we have discussed what financial projections are, and what type of financial projections start-ups use. We have not discussed though their importance. Why financial projections are needed? Why are they important for start-ups? (FasterCapital, 2023), (The Factory Works, 2019), (Financial Model Net). Let us see this.

- *Financial projections are the basis of a business strategy.* Financial projections represent a key component on which the decision-making process is based. Financial models created by these financial projections can be used by start-ups to try different scenarios and reflect on potential changes in the business strategy. For example, the company can create different scenarios by changing different variables and then see what the consequences of them in the level of profit are.
- *They are a key component of any business plan*. Financial projections provide start-ups with the information needed by the management when they are talking about important decisions, like raising capital, considering a divestiture or acquisition, and making a decision whether or not to enter new markets. They are the basis on which the plans of the company for the future are based and serve to orient the company to adjust its actions and decisions to move toward achieving the goals set in its business plan.
- *They are key factors in securing funding.* Financial projections represent one of the most important pieces of information that potential investors see when they are considering whether they shall invest or not in the company. They are used by potential investors to make a prediction of the future financial performance of the company, to see if it is worth investing in the company or not. Potential investors can use them to see if the company has the potential to generate revenues and become profitable. It is important to highlight the assumptions on which financial projections are based when they are being presented to potential investors. The key role that they play in securing funding reflects the importance of having accurate financial projections.

- *They can help measure the company's performance and compare it with the initial projections.* Financial projections help the company to simultaneously monitor its performance and see how its current performance is compared with the one projected. This gives the company a chance to see areas that have a negative impact on the company's performance and use that as a basis to take action to strengthen its weaknesses and improve performance.

- *They provide a roadmap for the company's growth and help in identifying potential financial problems very early*. Financial projections are the basis for evaluating the potential of start-ups to grow and since they offer a way for monitoring a company's performance, they help in identifying potential problems very early. This is critical for the company to take measures on time for avoiding financial problems that may come up. Taking measures before these problems happen is much better than getting adapted after facing them.

- *They help start-ups allocate their sources efficiently.* Financial projections contain many details and include details about how money is allocated to different activities. Since start-ups in general have limited sources, they shall be careful in the way they spend money. Having detailed financial projections helps the company to see how its sources are allocated so it can avoid overspending in different areas. This will result in an efficient use of resources.

- *They help to reassess the weaknesses and strengths of the company*. As previously mentioned, financial projections offer the company the chance to have a detailed look at the financials in the future that can help see what are its strength and weaknesses. This will help start-ups to find their weaknesses and work to improve and turn them into strengths. It is better to find areas where the company is weak and work to improve them instead of pretending that things are going well because that can undermine the future of the company.

- *They can help start-ups manage their cash flow.* Managing cash flow is critical for start-ups. Financial projections can help them have their cash flow under control and be able to monitor their burn rate. Burn rate is one of the key indicators that potential investors see when they are considering whether or not to invest in a company.

4.2 The Steps of Creating Financial Projections

Financial projections are the outcome of a long process and hard work that start-ups do. The work for creating financial projections includes some steps (Intuit Quickbooks), which are:

1) *Estimating the company's revenues and expenses.* In this step, the company needs to make a calculation of some of the key numbers that are related to the operations of the company. This includes making an estimation of the costs that are needed for the company to go on with its operations and an estimation of the revenues. There may be different revenue streams and the company shall make sure to make an estimation of all of them.

2) *Generating the projection of the balance sheet.* The second step includes the creation of the projections or balance sheet. In this step, it is important not to miss any details about different types of assets, liabilities, and equity. All the predicted changes shall be included in the projections.

3) *Generating the projection of the income statement.* After finishing with the projection of the balance sheet in this step the company shall move to the projection of the income statement. Creating the projection of the income statement will help the company to see how the final result will be if it will project to be profitable or to experience a loss.

4) *Generating the projection of cash flow.* This step, which consists of the projection of cash flow is important because the company needs to know how the changes in the cash balance are projected to be. This helps the company to see if there will be enough money in the bank account that can be used to make different investments and see what factors are leading to the change of the cash at the bank, from one period to the other. We shall keep in mind that a decrease in the cash balance is not necessarily something negative, because it depends on what is causing the money outflow.

5) *Reporting and sharing the findings.* After the company has finished with the creation of the projections of the income statement, balance sheet, and cash flow it needs to create a report based on these projections. The report may include different charts and graphs that may represent some of the key components of financial projections. Creating these reports can be important, because they may be presented to different stakeholders like investors, creditors, management, and other parties that may be related to the company.

6) *Monitoring performance.* The last step of financial projections consists of monitoring performance, which helps the company to compare the current performance with the one projected. This can help the company to find things that are not going well and take actions or measures to improve them.

4.3 Obstacles of Financial Projections

Creating accurate financial projections is not easy, especially for young companies that may not have a history of financial data. There are several obstacles that make the work of creating financial projections difficult (Cayasso, 2022); (The Factory Works, 2019); (Financial Model Net). Let us make a list of the key obstacles that start-ups face regarding financial projections.

- *Struggling with market research.* When start-ups choose to use the top-down method, they may struggle if the information that they need from the market is not available online. When industry information is not available, it may be difficult for start-ups to perform surveys by themselves.
- *Difficulties in striking a balance between optimism and realism.* This is one of the key obstacles that start-ups face regarding their financial projections. Since there is no history of their financials, start-ups shall create their financial projections by making assumptions about costs, target market, revenues, etc. It is common for start-ups to be over-optimistic while projecting revenues, which leads to unrealistic financial projections. It can be difficult for start-ups to avoid being over-optimistic and being realistic in their projections.
- *Overly optimistic projections can damage your credibility and make it difficult to secure financing.* Financial projections may need to be included in the business plan so it is important to be as much realistic and honest as possible. Since they are key information presented to potential investors, it can damage the credibility of the company and its efforts to secure funding.
- *Unrealistic personnel projections.* Many start-ups tend to have unrealistic personnel projections as well. While they tend to be over-optimistic and project high revenues, they tend to plan a small number of employees. This reflects the disproportion between the revenues and the number of employees, by pretending that a small team can be enough to generate high revenues, which is unrealistic.
- *Having unrealistic salaries.* For many start-ups is difficult to project the salaries of their employees. There is a tendency to be unrealistic because start-ups often try to take as a basis for projecting their employees' salaries, big and well-established companies. They shall understand that particularly in the first years when start-ups seek to secure funding, it may be difficult for them to pay their employees a salary that is comparable to salaries paid by big companies in the industry.
- *High cost of creating accurate financial projections.* One of the obstacles that start-ups face is related to the costs of creating accurate financial projections. A significant part of start-ups are not able to hire experienced professionals to create their financial

projections, because of money reasons. Not having a professional who can do that can result in the creation of low-quality financial projections and damage the potential of the company to secure funding. The problems that start-ups have with money can also put them in a situation in which they cannot afford to buy software that may be needed to create financial projections.

- *Inaccurate input data availability, reliability, and quality of the input data.* It can be difficult for start-ups to create accurate financial projections when the data used to create them is not available, is not accurate, or is not reliable. If the information needed is not available, and the company needs to make any assumptions this can lead to compromised financial projections.
- *Difficulty in meeting forecast assumptions.* Even when the information needed for creating the financial projections is available, it may be difficult for the assumptions to be met. This can be difficult particularly when projections include a long period of time. This means that during a longer period of time, many things can change, that include market volatility and changes in economic conditions. This makes it difficult to meet the assumptions on which financial projections are based.
- *The complexity of financial modeling.* Financial projections are the basis of creating a financial model. Conducting a sensitivity analysis can be tough, particularly when there are many assumptions that can be changed and to check the respective results. The more complex the business model and the more assumptions done, the more difficult it will be for start-ups to create accurate financial projections.
- *Time-consuming validation, data entry, and formatting.* Financial projections include a lot of information and creating them may be a long and exhausting process. People who work on creating them shall enter massive amounts of data and shall be careful to format correctly the data and to make sure that there are no mistakes otherwise it would lead to false financial projections. Formatting is important too, particularly when conducting the sensitivity analysis, to make it easier to get the results as the assumptions change.

4.4 Creating Accurate Financial Projections for Start-ups

There are several mistakes that start-ups can do while working on their financial projections. One of the mistakes they commonly do is using unrealistic assumptions, by being over-optimistic with the projection of the assumptions (Grenfell, 2020). It is difficult though to be realistic, particularly when the information needed for the financial projections is missing and making any assumptions to fill in this gap is needed. They also tend to underestimate the importance of marketing expenses, which can play a crucial role in creating awareness in the markets, and target audience about the existence of the company and the solution it offers. A mistake that start-ups often do is projecting profits too early or too high, by being over-optimistic on their projections. This is then reflected in the calculation of the break-even point. They also tend to plan a significant growth rate in sales with an insignificant increase in the headcount expenses, which is unrealistic and disproportional. Another mistake they do is the underestimation of development costs and costs related to regulation, and certification. There is also a tendency to think that they are certain about what the future will bring.

How can start-ups avoid these mistakes? There are several ways that start-ups can consider to avoid making these mistakes and create accurate financial projections (The Factory Works, 2019). Let us see some of the ways that can help start-ups create accurate financial projections.

- *Know your costs.* It is important that before starting to create the financial projections, the company shall know very well its costs, including here variable and fixed costs. Having a clear picture of the costs can increase the chances to have accurate financial projections.
- *Use historical data.* If the company is a young one, it does not have a financial history to use for creating projections, so it has to make assumptions for doing that. In contrast with start-ups, well-established companies have a history, so they can use it to create more accurate financial projections.
- *Make conservative assumptions.* Since start-up financial projections are based on assumptions, this increases the chances of doing errors, especially when they tend to be over-optimistic. To create financial projections much correctly as possible, start-ups shall try to be cautious about their assumptions. It is better to be surprised for the better than get disappointed when the current financials are significantly different, in a negative way, from the projections.
- *Plan for contingencies.* Planning for contingencies can also help in creating accurate financial projections, because it gives the company the chance to get prepared for unexpected changes, like sudden increases in costs or lower levels of revenues compared to those planned.
- *Update your projections regularly.* It is important to continuously update financial projections as things change. If the business grows, its costs and revenues will change, so it is important for these changes to be reflected in the financial projections. This is needed to keep them as much accurate as possible.
- *Use market data.* When start-ups are making an evaluation of their target market it is important to use market data, to be as much accurate with their calculations as possible. This information can be collected from primary or secondary research. The more accurate this information, the more accurate will be the financial projections.

- *Account for uncertainty.* It is important for start-ups to know that there are many factors or unexpected events in the future that can cause changes in their financial projections. It is important for start-ups to be conscious that they are not certain about what the future may bring and try to take measures to get adapted to unexpected changes.
- *Include factors contributing to low-cost growth.* Another important way of creating accurate financial projections is by identifying and including those factors that can contribute to a company's growth at a low cost.

There are many benefits to having accurate financial projections. It can help the company control the cash flow and find ways to improve it. Creating accurate financial projections can also contribute to allocating the sources efficiently, improving the decision-making process, and increasing the negotiating power of the company when pitching to potential investors.

5. Conclusion

The aim of this paper was to make an analysis of some key obstacles that start-ups face while creating their financial projections. The research found that the characteristics of start-ups as young companies tend to be a key reason why they struggle to create accurate financial projections. There are many mistakes that start-ups do when creating their financial projections, like making unrealistic assumptions, underestimating development, and marketing costs, and projecting profits too high or too early.

This research found that there many obstacles that start-ups face while creating their financial projections, like struggling with market research, having unrealistic personnel projections and salaries, difficulties in finding a balance between being optimistic and being realistic, complexity of the financial model, and high cost of creating financial projections. There are ways though to overcome these obstacles. One of the key obstacles is being over-optimistic with the projected financials. Keeping a balance between being optimistic and being realistic is key to creating accurate financial projections.

Taking into consideration potential unexpected events and updating all the input data is key to having up-to-date financial projections. Other ways that can lead to accurate financial projections are planning for contingencies, making conservative assumptions, using market data, and including factors that contribute to low-cost company growth. Striving to create realistic financial projections can have a positive impact on the way potential investors see the company and their decision on whether or not to get involved in the company.

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