

Tech start-ups need a different approach to financial management



We find ourselves today at the start of an industrial revolution. There have been others of course. The first revolution happened 250 years ago. Its engine was mechanisation. Another, about a hundred years ago, was all about electrification and mass production. Then 50 years ago, electronics and automation started a third revolution.

Right now, our physical and virtual worlds are converging. This is revolutionary because the way we produce, consume, move, communicate and interact are fast altering. What's different is that as the first three revolutions evolved, not many people then knew much about the scale of changes taking place. But in the present day, signs are all around us that we are in a period of transformation that is truly epochal.

As the fourth industrial revolution takes hold, the physical and digital worlds are merging, opening up huge possibilities for reconfiguring our activities and exchanges. Coupling digital technologies with commerce requires a different approach to the financial management techniques that have been regarded as relevant to conventional industrial-era businesses.

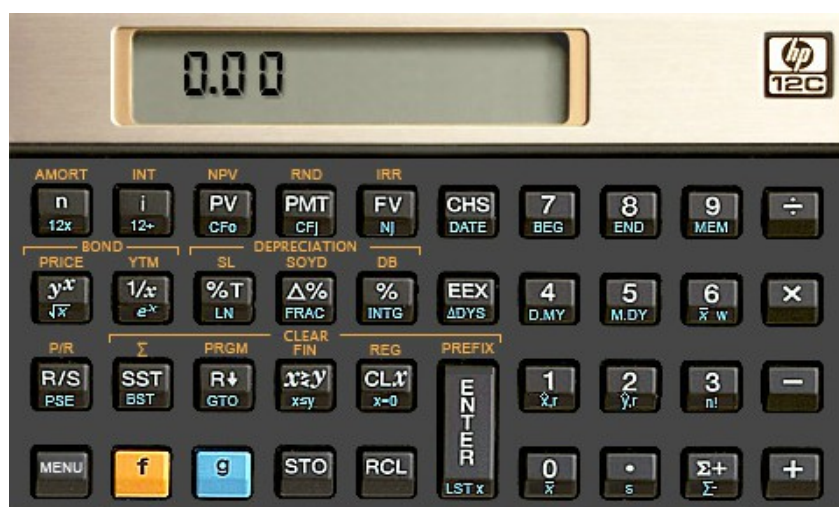
What is the purpose of accounting controls and financial management?

In my new [book](#), I discuss empirical illustrations and approaches that are appropriate for tech-based business innovations. My research shows that traditional financial management does not provide the financial lens entrepreneurs can use to track their start-ups through growth phases or to meet investor needs for tech-business financial and non-financial information. Growing a tech start-up makes it essential to appeal to an alternative approach to financial management which considers different loops of financial control and different ways of tracking tech start-up performance.

But a legitimate question often asked by entrepreneurs is what purpose do accounting controls and financial management generally serve? If we accept that the *raison d'être* of any business is always to create value in some way, then financial intelligence becomes essential in considering: *Is the business creating value? Is it creating as much value as it set out to? Is it using the fewest resources to generate the most value possible?* It's no surprise also that investors need to assess the financial adeptness of business founders seeking funding, since half of small businesses fail within a year in the US, and almost 90 per cent of business failures are due to management mistakes, including a lack of financial responsibility and awareness.

In the UK, studies have shown that more than one third of business failures are due to founders having a poor understanding of financial management. Inadequate financial understanding is also viewed as a key reason for start-up failure across Europe, the Middle East and North Africa and other countries including India, China, Australia and Brazil, among others. This means there is another question to address: *Are investors convinced that the start-up they are investing into has the financial intelligence to operate properly?*

Tech entrepreneurs cannot rely on conventional accounting. Investors in tech start-ups will want to set targets and they'll want financial and other information about the venture idea and, if funded, its subsequent progress. Tech entrepreneurs need a specific lens that enables them to home in on financial strategies that are in tandem with their cost structures and business objectives. For reasons explained below, they cannot rely on conventional accounting and need simpler and more direct ways to answer these questions. So, tech entrepreneurs need financial and other metrics to manage the business and also to satisfy investors' requests for information.



What type of financial understanding is appropriate?

So what makes tech-based business models different from other entrepreneurial ventures and what type of financial understanding is appropriate? At the heart of technological change lies disruption. Start-ups experiment with different ways of using technology, usually to come up with new forms of benefit for consumers. Business models in tech firms may hinge on better quality of supply, more transparent service, lower prices, new ways of bundling services and often entirely new drivers of value that will create their own further market needs. So we shouldn't expect that where technology has advanced apace and business models have rapidly evolved, financial management understanding should stay still.

Consider some ways in which innovations in technology have altered the financial circuitry of tech businesses. Many traditional industrial firms rely on producing in large quantities, making money through economies of scale. They can undercut smaller businesses by focusing on supply, like bulk buying, to push down their material costs. They can also invest in faster and more flexible technologies. As their costs fall, their efficiencies rise, and they become profitable and large within their industrial sectors. But many tech firms focus much more on demand. They use technological innovations to create and expand networks.

The growth of networks becomes self-reinforcing since users get value out of connections and so connections grow further. The larger user base in the network increases demand for the product, which in turn fuels more network expansion and demand. Sometimes, networks connect with other networks creating even more value. If business transactions grow because networks expand in many directions and defy linear pathways, then using financial intelligence that only focuses on supply and that only tracks linear paths of value creation is inappropriate.

Tech firms vs industrial organisations

Consider also the difference between tech firms and industrial type organisations in relation to financial management needs. Tech business models advance as continuous evolution-through-experimentation takes place. They are not like traditional business ventures, where resources required are assessed in relation to anticipated market needs for a product with a known value. There is no certainty in the way product-market fit evolves. A tech firm may want to test out an altered product angle, toy with a new website feature, explore building relationships with influencers, try out a differentiated pricing scheme, play around with a mobile-responsive template, work out novel organic tactics to increase online traffic, and so on. Some experiments will have tiny business repercussions, while others could unleash strategic-level changes. From a financial viewpoint, specific ways of tracking activities that help determine what actions to take, and when to do so become essential. The novel focus of financial and accounting controls is to help start-ups to closely track and monitor experimental activities.

With some digital business platforms, where customers make cash, the tech start-up takes a cut. If the model is premised on a 'sharing economy' logic, then value creation is brought about by accessing existing supplies that have not been commercialised. For tech platforms like Airbnb and Uber, the object is to bring users who need a service or product to come together with suppliers who have unused capacity, benefitting all parties. Traditional suppliers such as taxis, trains and other pre-existing transport services would have had to invest into new resources to bring to life their business model. But with tech start-ups entering this business space, existing supply sources are unleashed, bringing spare capacity onto the market. As a result of supply increasing, the traditional providers will have to share customer spend with the new suppliers. This brings down prices across the whole industry, as there's so much more supply. Some profits go to the new suppliers of spare capacity, and some to the consumers who now have more choice with lower price points being available.

Investors in tech-businesses have specific information needs

Naturally, investors considering funding ventures will assess whether there exists risk-return balance of the type they are seeking. All investors will look at how viable a concept is from the outset, and how well the venture will likely develop successful operations in the longer run. For any start-up, there will be an assessment of its business hypothesis, the potential market and the team in particular, to be confident that they can deliver.

In terms of the product concept and market, an investor will look for competitive differentiating features. Perhaps the start-up can better execute something that already has an existing market. Or it might offer an entirely new business model or market to be developed. For tech start-ups, the focus may be on whether, perhaps, the product has lock-in capability where, as we saw earlier, there is resistance for a customer to move away once they've adopted a product in terms of effort and time.

The crucial roles of the founder and the team

If the concept enjoys network effects, this could be a very attractive opportunity, where fast business development and growth become important. The investor will also want to see whether there is uniqueness in the technology, and how far the concept has been developed by the time they step in. Part of investor concern will be with the founders. The team needs to have both solid technical expertise and sales orientation. It also needs to be comfortable with acting on advice, and be flexible around inventors' executive approach and decision-making. This could include times when the investors signal a need to advance the business along a new trajectory. Investors will likely not want a team showing resistance to evolving their product concept or business model. A founder who only wants to stay with the start-up short-term, or wants to stay in a specific role long-term, or who does not show an understanding of the financial dimensions of navigating the start-up to success, will not impress investors.



Notes:

- *This blog post draws on insights from the book [Financial Management for Technology Start-Ups](#) (Kogan Page, 2017) by Alnoor Bhimani*
- *The post gives the views of the interviewee, not the position of LSE Business Review or the London School*

of Economics.

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