By Jeff Epstein & Byron Deeter
Bessemer Venture Partners

Adaptive Insights

The Goldilocks Budget

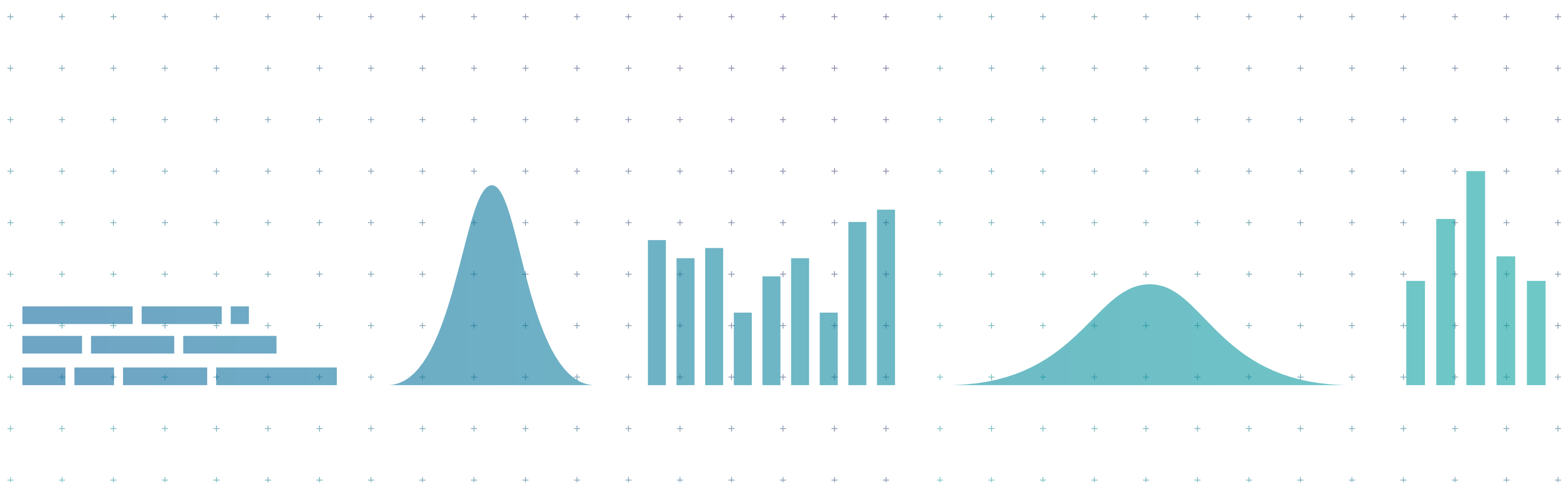
Best practices for developing a “just right” budget for your business

EFFECTIVE BUDGETING

As with so many things in life, the key to effective budgeting is to find the right balance. Yet achieving that balance can be challenging. At some organizations, intense pressure for rapid growth from senior leadership or the board of directors pushes finance to develop an overly aggressive budget. While that keeps the peace in the short term, the likelihood that actual performance will fall short of budget projections leads to tension and distrust down the road.

Meanwhile, the opposite approach—hyper-conservative budgeting—is rife with a different kind of risk. Setting the bar too low eliminates the aspirational potential of a budget, possibly thwarting needed investments and avoiding useful stretch goals on the revenue side that could be essential for driving growth and maintaining a competitive edge.

This challenge is further heightened by the fact that the approach to business budgeting is usually viewed as an all-or-nothing proposition. Finance teams are locked in to creating budgets that are either overly aggressive or too conservative, and struggle to find a middle path that creates a balance between a budget that both reflects the reality of the organization's financial capabilities while also providing for stretch goals that set targets for growth.



Yet there is a better way: the Goldilocks Budget. That's right, Goldilocks. As you may recall, in the fairy tale Goldilocks and the Three Bears, it takes young Goldilocks three attempts to settle on the food and accommodations that she finds "just right" in the bears' house. Breaking-and-entering violations aside, the tale offers an easily accessible reference to creating a budget for a business that provides options and aims for the just-right sweet spot that effectively balances the myriad goals of a good budget.

> Breaking and entering aside, Goldilocks' tale offers a dynamic budgeting approach.

Specifically, a well-crafted Goldilocks Budget can help you achieve three clear goals:

- Motivate your teams to perform and achieve at their highest levels
- Invest resources in the highest-priority projects
- Protect the company if things go wrong or unforeseen challenges arise

Ultimately, the Goldilocks approach provides a logical and systematic process for creating a business budget that is "just right." It avoids the damaged credibility or risk of cash shortfalls that comes with aiming too high, and the slow growth, competitive risk, and potential for lower valuations that come with aiming too low. The key catalyst that drives a Goldilocks Budget? *Applying probabilities to the budgeting process.*

What follows will provide context on how Goldilocks budgeting offers a proven approach to achieving that balance while also driving better results and enhancing communications, confidence, and transparency with your board and senior leaders.

APPROACH

"How aggressive should we be when we set our budget?"

That's one of the most common questions we get from CEOs, CFOs, and FP&A leaders. The short answer: "Good question!" The reality is there is no one answer. Each company—particularly those without a long track record of performance and results—is uniquely different. Each has different challenges and targets, industry-specific obstacles, and a range of other factors that will weigh heavily on how a budget is constructed and what it aims to achieve for the organization. The level of disparity and differences often leaves finance pros in a quandary over whether to take a conservative or more aggressive approach to budgeting. Adding to the challenge is the need to understand the expectations of board members, many of whom will bring preconceived preferences and attitudes to the budget process based on their past experiences. Against this backdrop, the key is to find an approach that:

- Provides a realistic and achievable budget
- Allows for the preferences and expertise offered by board members
- Creates an environment that encourages engaged and collaborative budget discussions—and discourages conflict
- Offers some level of flexibility for internal, industry, and economic changes
- Provides a framework for ongoing measurement of results and performance

The Goldilocks approach achieves these goals by creating a framework for a budgeting process that contains a certain degree of elasticity without compromising the integrity and value of disciplined budgeting. This is achieved through recognizing and effectively communicating probabilities in budgeting and forecasting. For instance, if a company achieves its budget four out of five years, it is budgeting at an 80% probability.

So how does that play out in real life?

To move forward, begin by looking back. Assessing your organization's history of budgeting and related performance can help develop a baseline for the Goldilocks Budget as well as unearth some relevant insights. This early step in the process offers the first opportunity to present the Goldilocks Budget approach to your CEO and board of directors.

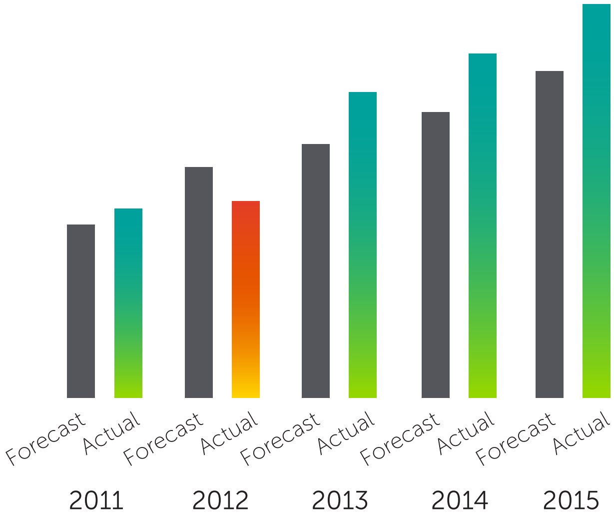


FIGURE 1
Review of budgets actually achieved

Review how many times in the previous five years you achieved your budget. If you achieved it four out of five times, is that a good thing or is the organization aiming too low? Conversely, if you missed four out of five years (for only a 20% success rate), is the budget unrealistic and a source of frustration throughout the organization?

After reviewing and discussing that history, the next step is to ask: **What is the best budget for our company this year, for our sales quota, revenue projections, and cash flow targets?**

That question lays the foundation to create a budget that accounts for three potential scenarios across four different categories—sales and marketing; revenue budget and revenue forecasts; cash budgets and cash forecasts; and Wall Street guidance (for publicly traded companies).

Key components of the Goldilocks Budget

So from a practical standpoint, what are key components of a Goldilocks Budget? Further, what is the most effective budgeting approach to each of these components? Based on experience with hundreds of early-stage companies, Bessemer Venture Partners has identified the best practice probability of achievement for each of the components. Taken together, this typically establishes the framework for optimal performance and the best results. These target probabilities for achievement include:

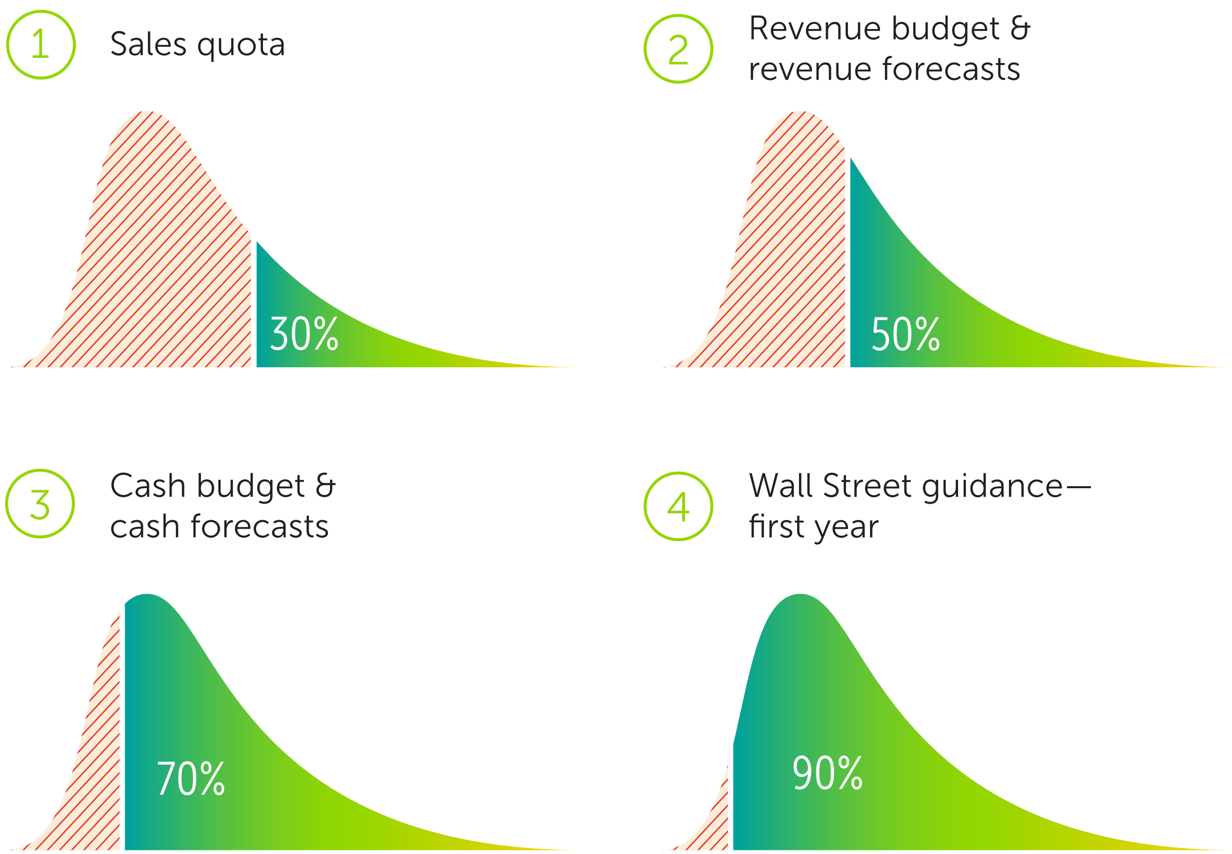
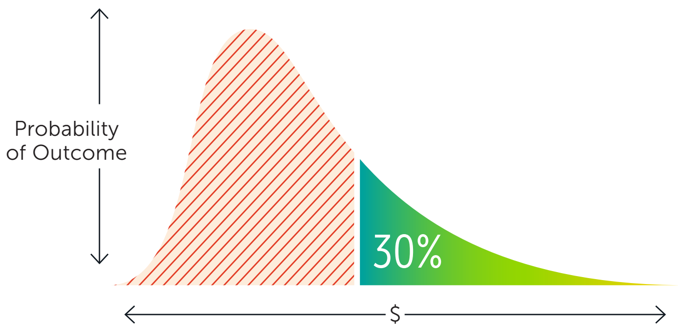


FIGURE 2
Best practice probability of achievement

An ambitious sales quota

Recommended target: 30% probability of achievement



A recent *Wall Street Journal* article profiling uber-entrepreneur and Tesla CEO Elon Musk focused on the frequency with which Tesla has fallen short of ambitious car production and financial targets. When asked about the misses, Musk was unfazed, noting he does not "set targets that I know can't be met."

The article continued: Tough goals keep Tesla moving forward. "In order to have a good outcome, we must strive for a great outcome," he said.

That mindset—striving for a great outcome—captures perfectly the approach that should be taken to sales targets within a Goldilocks Budget.

Sales revenue in the Goldilocks Budget consists of new revenue and recurring and upsell revenue. Sales represent the most ambitious budget targets, falling into the "too hot category" viewed in the Goldilocks context. This is for good reason. Fast growth is the lifeblood of venture-backed companies, and clearly it is the sales and supporting marketing efforts that are the catalysts for that growth.

So it's best practice to aim high here. Set ambitious reach goals. Even if they are not fully achieved each year (and the percentages say they won't be), establishing more aggressive benchmarks will likely lead to better results than setting more modest targets that are not as aspirational. Further, the other more conservative components of the Goldilocks Budget provide some downside protection if sales come up short.

No doubt, fast growth requires new revenues from new customers. Achieving that requires new marketing channels, new distribution partners, new products.

All of these are risky. Yet companies must invest in these risky new plans.

The 30% probability of achievement in any given year reflects that risk. It also communicates to your board and business line leaders that the targets are stretch goals, but ones that are achievable, and in fact should be reached roughly one-third of the time.

Past experience shows that companies using the Goldilocks Budget do just that, reaching their impressive goals, and with luck and hard work, going beyond to reach goals they never thought possible.

For companies where revenue is generated by marketing, not sales, the recommended marketing plan for new revenue has a 30% probability of achievement. For companies that have both sales and marketing generate revenue, it's best practice to have both a sales plan and a marketing plan.

Additionally, sales leaders will often assign individual quotas to their salespeople, which can add up to 10% more than their sales plans. This leaves room for some level of potential underperformance and attrition at the salesperson level.

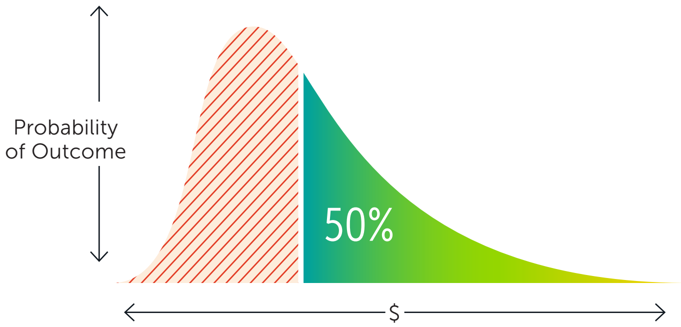
The Goldilocks Budget can also account for "bookings" when relevant. Many companies sign binding agreements with customers in one period that lead to material revenue in later periods. In this case, "bookings" becomes the key metric instead of revenue.

When it comes to sales, often "too hot" is just right.

Again, best practice calls for bookings to carry a 30% probability of achievement. Likewise, individual sales quotas for bookings total 10% more than the sales budget for bookings.

A revenue budget that reflects reality

**Recommended target:
50% probability of achievement**



Experience from Goldilocks Budget practitioners has shown that a revenue budget should be established with the target of a 50% probability of achievement in any given year.

This mirrors another industry in which the goal is to be as competitive as possible: sports.

Former Intel CEO Andy Grove, in *High Output Management*, points out that in professional sports, which is highly competitive, optimized, and measured, 50% of the players win every game, and 50% lose every game.

Pretty obvious, right? Yes, but that's the point. Hitting your revenues in any given year is a win-lose proposition—you either reach the number or you don't. That is why it is essential to set a target that is reasonably aspirational so as to create a clear, yet achievable, benchmark for revenue generation.

First, start by creating the more ambitious—and risky—sales and marketing plan that clearly establishes the organization’s stretch goals.

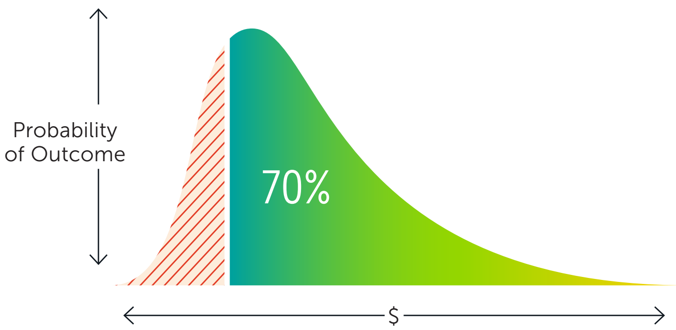
From there, you have a foundation for the more holistic revenue budget that builds in a cushion for unforeseen, yet likely, delays, surprises, and unexpected trends or events. Then, add in projected recurring and upsell revenue from existing customers.

Again, overall, best practice companies will hit their revenue targets 50% of the time. The beauty of the Goldilocks Budget is if you have a multiyear trend in which you are falling short on your revenue goals, it’s likely that your revenue projections are too optimistic. Conversely, if you end up crushing the revenue goal year after year, your projection is clearly not ambitious enough and should be adjusted accordingly in a way that it is achievable, but not in every single budget cycle.

STEP 3

A strategic cash budget

Recommended target:
70% probability of achievement



No matter what the business, the phrase "cash is king" most likely resonates—at least part of the time. Cash on hand provides a security blanket. It bolsters confidence, it reduces stress, and it generally is a strong indicator of a healthy business. Yet, having too much in reserve for too long of a time can be a problem.

With that in mind, best practice for the cash budget is a 70% probability of achievement. You should get there in most years, but the 70% probability still leaves room for the reality that at times cash will be tight because of challenging situations, and in other instances cash will be used to invest in and grow the business—even if that means less cash on hand in the short term.

The cash budget helps find a balance between what are often the conflicting roles of senior leadership: The CEO's job is to dream big and push for ways to achieve those dreams, while the CFO's job is to make sure the organization never runs out of cash.

"Cash is king" resonates for just about any business.

While it is easier to achieve budgeted expenses than budgeted revenues, even here surprises can throw a curveball into the budget. For instance, important customers may require extra R&D investment and customer support; unexpected employee turnover may lead to extra recruiting, training, and temporary employee costs; and technology transitions may result in higher operations costs.

A 50% probability of achieving the revenue budget combined with possible expense surprises creates too much risk for venture-backed CEOs and CFOs.

They want to insure that their cash burn, measured in dollars, and their cash runway, measured in months, at least meets their plan.

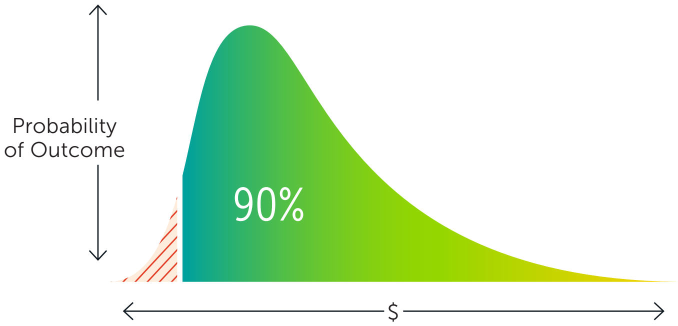
Best practice CFOs have a solution for this: the reserve. The reserve is budgeted as an expense line, set aside for unforeseen expenses or revenue shortfalls. The amount of this reserve should be sufficient for the company to achieve its cash budget 70% of the time.

This gives the CFO, CEO, board, and shareholders confidence that the company has the cash resources it needs to survive and prosper. **The reserve has an additional benefit for the C-suite. It allows the CEO and CFO to "under-promise and over-deliver." By doing so, they build credibility among the board, investors, the leadership team, and employees.**

STEP 4

Going public—Wall Street guidance

Recommended target: 90% probability of achievement



For companies preparing to go public, another key metric gets added to the Goldilocks Budget—Wall Street guidance. Guidance is typically more conservative than the budget. According to JP Morgan's analysis of 203 recent technology initial public offerings (IPOs), companies achieved their first- and second-quarter post-IPO revenue "Street estimates" (which are based on guidance) over 90% of the time.

When Credit Suisse reviewed 534 technology companies that went public since 2005, it found that companies achieved their revenue "Street estimates" 73% of the time.

In other words, public companies track to a 90% achievement level in their first year post IPO, then to about a 70% achievement level in later years.

These are good guidelines to be mindful of when developing a budget and the associated Wall Street guidance. **By building in the guidance component prior to going public, your organization can get a clearer sense of developing Wall Street guidance in ways that prevent damaging misses, but still provide a realistic view of your company's performance and potential.**

SAMPLE GOLDILOCKS BUDGET

Million $	Goldilocks Budget	Probability
Individual Sales Quotas*	$13.2	
Sales Quota	$12.0	30%
Revenue	$10.0	50%
Expenses	$12.0	50%
Reserve	$1.0	
Total Expenses	**$13.0**	
Cash Flow	$3.0	70%

FIGURE 3

* Sales Quota + 10%

Assess your operating environment

While the probabilities in the categories represent best practices based on experience working with hundreds of companies, they should not be rigid. **Each organization needs to view its Goldilocks Budget in the context of the current and anticipated operating environment, and assess the level of risk that may impact achieving budget goals.** For instance, if you are operating in a high-risk environment, in which it is difficult to raise money, you have high customer or supplier concentrations, or you've missed budgets for several years because of industry or economic factors, it's likely best to aim lower with your budget projections and target a higher probability for success.

FIGURE 4

Conversely, if the operating environment is low risk, you have been achieving—and exceeding—sales goals, and you're hitting budget targets consistently, then leverage the Goldilocks Budget to aim higher, setting lower probabilities that will reflect stretch goals for the organization.

Use quarterly forecasts to ensure the Goldilocks Budget stays relevant throughout the year

So you have built the Goldilocks Budget. You have gained critical buy-in from senior leadership and your board of directors. The budget discussions proved to be engaging and collaborative as board members gained a deeper understanding of the Goldilocks approach and how it provides a more holistic picture of the business, while strategically balancing the need to drive growth with the often challenging reality of running a business.

KEY CONSIDERATIONS

The budget, once approved, never changes, but the reality is that the world does change. The Goldilocks Budget, with its reliance on probabilities, accounts for this change and makes the assumption that these changes will be reflected in performance and results.

Yet, to fully leverage the benefits of this approach, best practice companies build updated forecasts quarterly that track and account for changes since their budgets were approved. Many companies issue forecasts monthly when conditions are changing quickly, and some even update forecasts weekly as part of their rigorous management practices.

Indeed, the ability to plan and forecast for varying market and economic conditions that the Goldilocks Budget provides aligns well with how many CFOs are focused on helping their organizations succeed. When Adaptive Insights asked in its CFO Indicator Q1 2016 Report how a CFO can provide the most strategic value during a market contraction, the most cited answer (48% of respondents) among the 377 CFOs surveyed was the "ability to plan for multiple scenarios."

Best practice forecasting uses the same 30/50/70% probabilities as developed in the Goldilocks Budget, updated with new information. For instance, after the first quarter, the full-year cash forecast will include first-quarter actuals, plus an updated second-quarter to fourth-quarter forecast. This is based on all newly available information and judgments, with an updated reserve aimed at reaching a 70% probability of achievement.

Foggy forecasts? Build a stagger chart.

One key way to improve forecasting accuracy is to develop a stagger chart, which was developed by Intel's Andy Grove. The chart tracks actual revenue growth for the business as well as how the forecasts for a particular month have changed with time. When forecasts fall out of line, it's a red flag for the team to investigate the cause, or causes, for the deviation.

Forecast			Forecast For			
Date	Jan	Feb	Mar	Apr	May	Jun
Jan	$100	$110	$121	$133	$146	$161
Feb	$102	$110	$119	$128	$139	$150
Mar		$108	$116	$124	$132	$142
Apr			$115	$122	$129	$137
May				$120	$126	$132
Jun					$125	$130
						$128
Key:	Actual					

FIGURE 5

Sample stagger chart—monthly forecasts

Note: Jan forecast for June was $161; Feb forecast for June was lower, at $150; March forecast for June was $142, etc. June actual was $128. The stagger chart shows that the forecast for June dropped every month.

Stagger charts build further accountability of a Goldilocks Budget, as Grove points out in *High Output Management:* The stagger chart "makes whoever does the forecasting take his task very seriously because he knows that his forecasts for any given month will be routinely compared with future forecasts, and eventually with the actual results."

Goldilocks accelerator: Link bonuses to plans

Obviously the 30% probability attached to the sales plan presents the biggest challenge—as well as the biggest opportunity—when operating under the Goldilocks Budget approach.

To help focus the organization on consistently clearing that 30% benchmark, it's best practice to base sales executives' bonuses on achieving their sales plans.

While sales plans will not be achieved every year, top-quality sales leaders will achieve their plans often enough, and when they do, are likely to be the highest-paid executives in the company. Bonus formulas are ramped, so sales leaders are paid well whenever they grow new revenue quickly, even if they fall short of their sales plans. In much the same way, marketing executives' bonuses are based on achieving the marketing plan. These bonuses can be tied to the Goldilocks Budget with a best practice of bonuses being paid with 50% based on achieving the revenue budget and 50% based on achieving the cash budget.

Often the cash budget part of the bonus is adjusted to account for extra investments specifically approved by the board of directors during the course of the year. Many companies pay "above-target" bonuses for executives and sales leaders when they achieve above-target results. Many companies pay bonuses for achieving specified operating goals, including year-end monthly recurring revenue, customer renewal and upsell rates, and customer satisfaction rates.

Avoid Q4 over-optimism

It's a common—and tempting—pitfall: adding a bit of extra revenue in the third-quarter budget projection and then projecting an even bigger jump in the fourth quarter.

Usually this occurs with companies that budget to ramp up hiring and marketing investments early in the year, with the thinking that it will result in a significant revenue boost in the fourth quarter. Companies that achieve their revenue budgets in the first through third quarter and then miss in the fourth quarter may even feel they're planning effectively, by achieving budget in three out of four quarters.

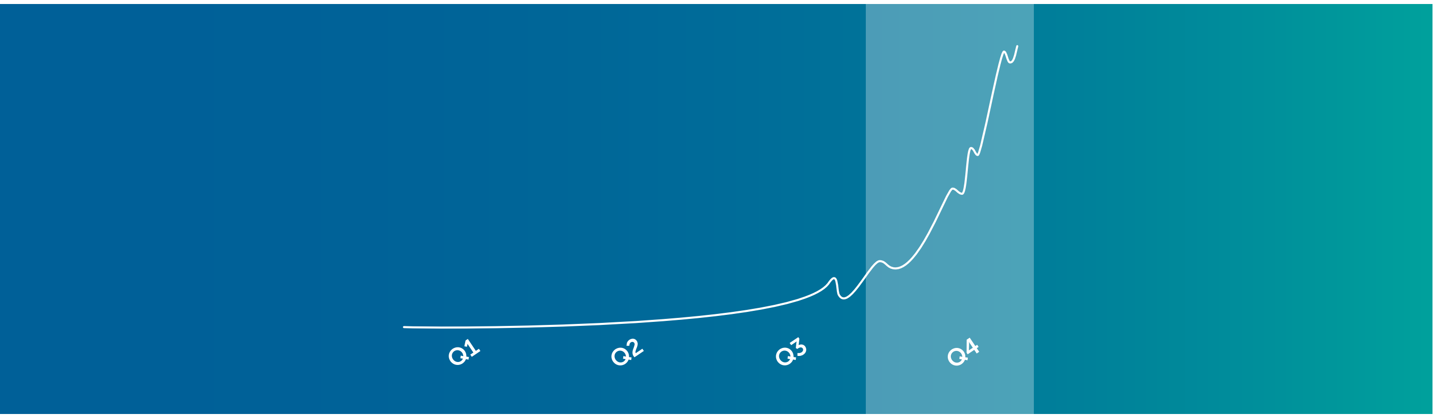


FIGURE 6
The revenue run rate at year-end is most important.

Leaders and boards of directors who believe this are deceiving themselves. **The most important revenue of the year is the revenue run rate at year-end, which establishes the base for recurring revenue the following year.**

Best practice companies achieve their fourth-quarter sales plans, marketing plans, revenue budgets, expense budgets, and cash budgets at least as often as their plans for the previous quarters.

The exception: a midyear course correct

While it's best practice not to change a Goldilocks Budget once established for the year, there is one exception—the need for the midyear course correct. If, for whatever reason, you are far off your year-to-date budget in June, it may make sense to reformulate your budget based on current and expected realities. Well-known venture capitalist and entrepreneur Brad Feld is a strong advocate for this "first half, second half" approach to budgeting if conditions warrant a midyear reset. As Feld points out in his blog, FeldThoughts, this is just a practical, common-sense move, because if you are not tracking close to budget, then the original budget serves little purpose in the day-to-day operations of the company.

If this is the case, trash the existing budget and come up with a new one for the second half of the year. Yet, importantly, stick to the Goldilocks framework. Set the new budget based on current information with the same probabilities, likely 30/50/70%, if following best practices. As far as associated bonus plans, typically bonuses for the first half of the year would be zero, but bonuses for the second half would tie to the new budget.

The Goldilocks effect—better budgeting, improved transparency

The Goldilocks Budget is one of the best ways to balance growth with predictability, but its value is enhanced if there is buy-in from the CEO and the board. Key to gaining that buy-in is to start having open and frank discussions about budget scenarios and the probabilities of various outcomes.

At first, this may be uncomfortable, because CEOs and board members are often used to finance presenting with a budget that is buttoned up and leaves little room for flexibility. Yet, by highlighting the benefits of the Goldilocks approach in which probabilities help guide budgeting and ultimately decision-making, you can start to win converts who begin to see the potential of this probabilities-based approach. **An added benefit of walking through the Goldilocks approach with senior leaders and the board is it further positions finance as a strategic partner within the organization. As the pace of business quickens and becomes increasingly complex, providing strategic insights is ever more valuable to the organization. Consider that in the Adaptive Insights CFO Indicator Q4 2015 Report, 75% of CFOs surveyed cited understanding strategy at both a business and finance level as the most important skill for CFOs over the next five years.**

Under-promise. Over-deliver.

It's especially important to have the probability discussion with your board. You may even want to survey the board members before the discussion to determine their probability expectations for meeting revenue and cash budgets. Don't be surprised if you learn your board members have widely varying probability expectations. If so, it's even more important to discuss this with your board and to reach agreement on the optimal budget probability for your company.

Once you gain consensus on the most useful budget probabilities, you have put your organization in an excellent position to succeed. You can grow as fast as possible, investing in new programs while at the same time being able to under-promise and potentially over-deliver on your cash budget. Bottom line: Goldilocks offers a budgeting approach that is clearly "just right."

Jeff Epstein is an operating partner at Bessemer Venture Partners, specializing in marketplaces and cloud computing. Epstein is the former executive vice president and CFO of Oracle. He serves on the boards of directors of Kaiser Permanente, The Priceline Group, Shutterstock, Global Eagle Entertainment, and several private companies.

Byron Deeter, a partner at Bessemer Venture Partners, leads the global cloud practice and has been actively involved in a portfolio that now includes over 100 cloud investments worldwide and represents more than one-third of the market cap of all public cloud companies.