The Financial Model:
At the Core of the Business Plan

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Long Term Goals & Objectives
Financial Objectives
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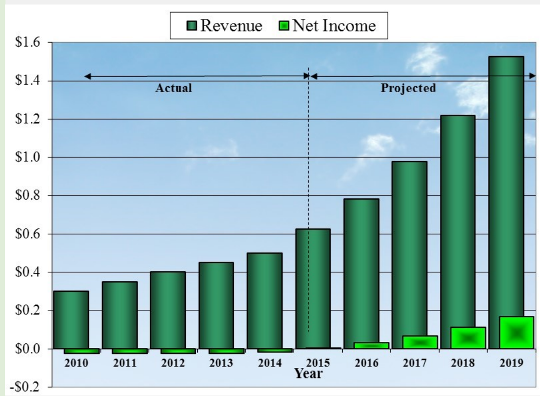
Financial Planning

Market Assessment

- Demand
- Competition
- Pricing
- Sales Forecasts
- Scenarios
- Marketing Plan

Financial Model



Internal Economics

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THE FINANCIAL MODEL: AT THE CORE OF THE BUSINESS PLAN

Business plans serve many purposes, from raising capital to internal management. Regardless of the goal, business plans have certain common characteristics. They begin and end in the executive suite and the boardroom. But a business plan must involve key executives and, depending upon the size of the organization, middle management and department heads in order to incorporate the specialized knowledge and experience that is essential to a realistic business strategy that can be successfully executed. This article discusses the role of the financial model in a business plan.

ESSENTIAL INGREDIENTS OF A BUSINESS PLAN

Discussion of a financial model would be pointless without first defining the purpose of the business plan of which it is an important component. Here is the author's list based on his professional experience and input from numerous other professionals.

1. **Description of the Company or Organization**
    a. Mission/business objectives
    b. Form of organization, e.g. C corporation, LLC, 501c3,
    c. Products and services currently offered
    d. Management and other key personnel
    e. Significant corporate developments, e.g. new products or markets, acquisitions, divestitures, etc.
    f. Organizational strengths and weaknesses (optional but useful).

2. **An Overall Statement of Business Strategy** that pulls together all of the ensuing components in a coherent whole. (Typically, this statement begins as a concept but is the last to be completed because it requires input from all the elements below.)

3. **A Marketing Plan for New and Existing Products and Services.** It is impossible to over-emphasize the importance of deep and insightful market intelligence. Market analyses often fail to understand who will actually buy the product or service and why. Essential components include:
    a. Market sizing, assessment and segmentation
    b. Product and service descriptions
    c. Matching of buyer behavior & needs with products or services offered.
    d. Competitive analysis
    e. Pricing and value analysis
    f. Resulting product/marketing strategy

4. **Business Model Viability (Proof of Concept).** New products and services are often conceived without knowing whether they are economically viable - sometimes despite overwhelming evidence to the contrary. Evidence is not always available, but management should make every effort, through market research, product testing, forensic research and competitive analysis, to obtain evidence of the viability of their business model. Outside investors, especially those burned by the dot.com bubble, will typically demand such proof..

5. **A Product Development Plan**. The time and cost of product research, development, testing, etc. is often overlooked or underestimated, most typically in young organizations. Such oversights can cannibalize capital intended to fund other activities.

6. **Product or Service Delivery Plan**. The successful delivery of the goods and services is essential to the success of any organization, be it health care services or the manufactured products. Cost of goods or services sold is often the largest component of expenses and therefore the economic wellbeing of the organization. So the plan to create and distribute goods or services to the end user or customer is one of the core elements of any business plan.

7. **Legal and Regulatory Considerations.** Regulatory approvals, licensing requirements, intellectual property rights, non-compete clauses are just a few of the legal and regulatory considerations that must be part of a business plan in the 21st century.

8. **Organization/Staffing Plan** that supports all of the above represents another critical element of a business plan for reasons too obvious to belabor here.

9. **A Financial Plan** that takes all of the above elements into account includes:
    a. Revenue and cost projections for each product or service
    b. Income Statement (at least 3 years historical and 3 to 5 years forward).
    c. Balance Sheet and Cash Flow Statement
    d. Investment and working capital requirements
10. **External Funding Requirements** (optional) net of internal capital generated.
11. **An Exit or Sustainability Plan.** While the exit strategy is the holy grail of many startups, other organizations (especially non-profits) intend to sustain their mission, or variations thereof, for generations. Short and long term economic viability is no less important to them, perhaps even more so, than for entrepreneurial organizations designed to enrich founders, management and investors.

There are as many variations on the above list of essentials as there are consultants. But regardless of whether the intended audience is outside investors or the board of directors, there is no substitute for substantive knowledge of the organization, marketplace, competition and business economics coupled with a realistic strategy to sustain or grow or sustain an organization.

Role of the Financial Model in Business Planning

Business planning often becomes fragmented when it leaves the executive suite, with marketing, production, finance, research and development and human resources each developing their individual plans based on their understanding of broad parameters laid out by top management and on each group's specific knowledge of the subject matter.

What comes back to the executive suite from various functional areas or departments may not mesh. Inconsistencies can develop from one department to another either through lack of lateral communication or due to legitimate differences of opinion or perceptions. Those inconsistencies must then be identified and resolved by top management, but they are not always obvious. Yet resolving them can be crucial to the success of a business plan.

One of the ways to detect and resolve interdepartmental inconsistencies is with the development of a financial model. The components of a business plan must also come together in the financial model, and inconsistencies or conflicts will show up during the development of the model.

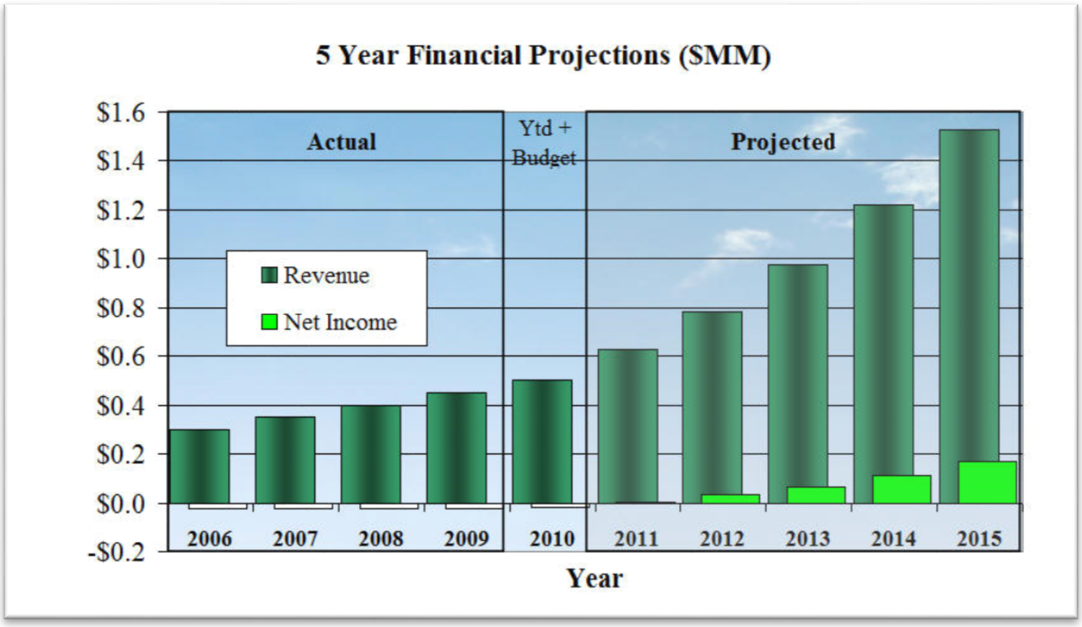
The creator of the financial model needs to be able to recognize those inconsistencies, understand top management's objectives and communicate effectively with all parties to bring the components of the business plan together as an integrated whole.

Essential Ingredients of a Financial Model

Building a financial model that accurately describes the economics of an organization as well as the market potential of its products or services in various market segments requires an understanding of all major aspects of the organization from marketing to personnel. Some essential ingredients that we typically include in our financial models include:

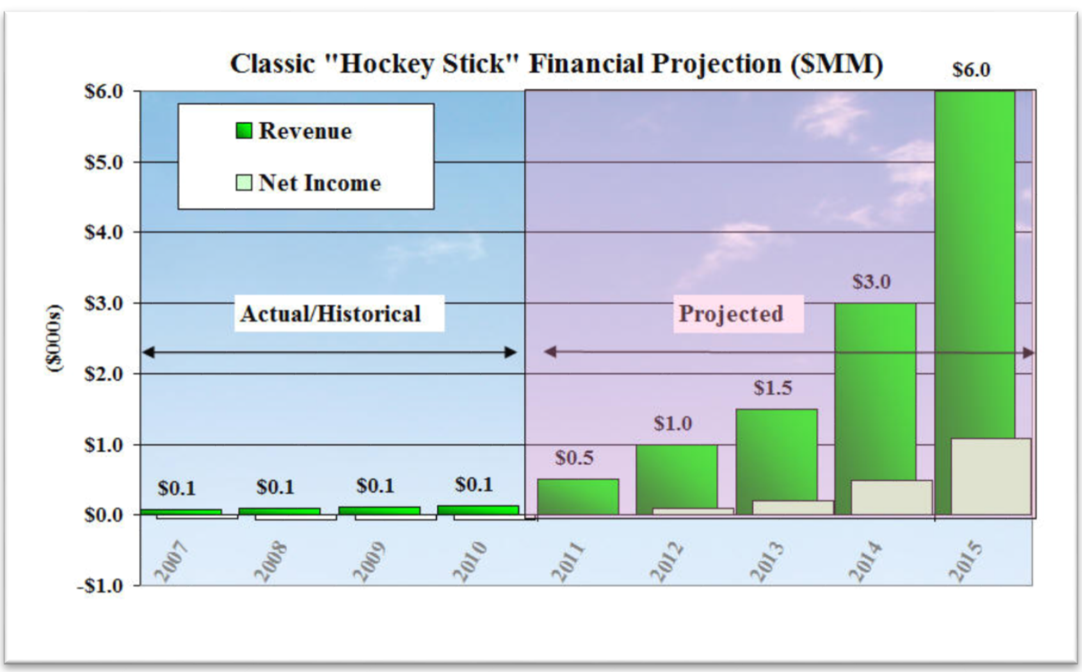
- Income Statement, Cash Flow Statement and Balance Sheet linked together so that changes to one are automatically reflected in all three.
- Variable, fixed and semi-fixed costs that accurately reflect changes in sales or production volume.
- All assumptions, e.g. percentage growth rates, entered in separate cells or spreadsheets so that they can be reviewed and changed, if necessary, without rebuilding the model.
- Sign-offs on assumptions by key personnel, e.g. sales, marketing, production.
- Back testing using historical data to determine accuracy of model.
- Review of applicable regulatory requirements.
- Multiple scenarios, typically optimistic, pessimistic and most likely.
- Discounted cash flow to determine current enterprise and equity values.
- Review of capital requirements and adequacy of current capital resources.

A good financial model needs to be sufficiently granular to accurately reflect the current business but flexible enough to enable top management to evaluate new business strategies and tactics using various scenarios. Inspiration often results from the rigorous process of describing the business plan in a financial forecasting model trying out (gaming) multiple scenarios. The resulting insights can make the difference between an ordinary business plan and one that guides top management in its decision making with respect to finance, marketing, products or services, organization, etc.



Accordingly, the builder of the financial model needs to have sufficient business experience and judgment to challenge weak or false assumptions and interpret responses while promoting harmony among the operating departments.

Common Problems with Financial Models



aAs an investment banker and financial advisor, I’ve seen literally hundreds of financial models. For a variety of reasons they often go off the tracks. They can be too simplistic or too complex. The analyst's assumptions, often unstated, may vary significantly from those in the business plan or management may change its assumptions based on developments that occur after the analyst received his or her assignment.

Typically, financial models are not built to accommodate a range of variable assumptions by top management. And in many models we have seen, changes in the income statement are not reflected in the cash flow statement, resulting in capital requirements that are significantly under- or over-estimated.

And then there's the classical hockey stick projection. Sales of a previously slow growing or marginally profitable company begin to grow rapidly and profits skyrocket in the future. Nothing can turn off a potential investor faster than a sudden, incredible departure from past experience, which is typically based on a failure of management to acknowledge the realities of the business it is in.

Often these deviations result from assigning responsibility to a junior analyst who doesn't have the business knowledge, experience or access to top management necessary to build a financial model that accurately reflects the business plan. Or there isn't adequate feedback, testing of scenarios and adjustment of the business plan once the model has been built. The value added of a financial model is considerably diminished if the creator does not participate proactively in the planning process.

Example: A healthcare organization for which the author was building a valuation in preparation for a possible merger had developed a very detailed in-house financial model with projections of various cost components and annual price increases that it considered reasonable. The resulting projections, however, showed an ever increasing profit margin that departed from its own past experience and that of competitors and other industry participants. The author made one simple change to the model. He posited a target profit margin, e.g. 3.5%, which would be more than adequate for the non-profit owner and much more in line with past and competitive practice. The target profit margin approach was embraced by management after minimal discussion as much being more realistic even though the effect was to reduce the valuation of the company.

Our Preferred Approach

By interviewing key personnel we quickly develop an understanding of the key determinants of product mix, pricing, sales and costs. Often we start with an in-house model that incorporates detailed product pricing and cost information and adapt it to create a useful planning tool for top management. While in-house models are usually built from the bottom-up, we build our models from the top down – reflecting past reality then refining the model as necessary to reflect future changes. Both approaches are useful, especially when the achieve synchronicity.

Along the way we challenge the assumptions! As the resulting financial projections begin to provide insight into the company's economics, we review those preliminary findings and assumptions with management. Typically, the review process results in changes or refinements to the underlying assumptions and may suggest alternative scenarios to be tested.

Not infrequently this feedback process results in adjustments to corporate goals and objectives, product or market emphasis or the way in which the enterprise organizes to grow. As we refine the model we begin to develop insights into the factors that are critical to the future success of the organization (Key Factors for Success). These insights, in turn, often lead to organizational recommendations, product pricing, market sector emphasis and possibly even mergers or acquisitions.

In essence, this is the application of the McKinsey approach, i.e. targeted analysis that leads to logical conclusions about corporate strategy, the GE approach, which builds strategies based on rigorous product/market and economic analysis and the Wall Street approach oriented toward investors.

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We have been building financial models for over 30 years. We know how to prepare multiple scenarios and make executive presentations. On Wall Street we used financial modeling to create complex debt financing structures and to assist clients with debt capacity analyses and stock valuations.

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