

Financial Business Modeling can Help Executives Predict Outcomes

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Basic Assumptions Related to a Business Decision

Executives base major financial business decisions on a series of assumptions most often centered on risk and cost. For a new line of goods, risk factors include projections, such as, “The new product line will grow at X rate.” Or, if a plant needs updating, they want the hard facts related to expenditures, such as, “The cash requirement to implement a new piece of equipment is Y.” The key is to determine how costs and the associated risks can be managed.

However, business is very much like real life—things hardly ever go as planned. The best way to get a handle on costs and associated risks is to frame the basic assumptions in such a way so that the decision’s determining factors are geared toward ensuring the outcome is realistic. In short, the executive should run all variables through a financial business model to help with their decision making process.

Objective and Subjective Data Points

Taking one step toward making a good decision, an executive should evaluate numerous data points to determine how they might affect the end result. There are two types of data points: objective data points that can be assigned a numeric value and subjective data points that are difficult to quantify.

An example of an objective data point would be something such as the tooling for new packaging, which could be expressed as “X dollars, which is depreciated over a three-year life at Y

dollars per month.” In the process of developing a financial business model an executive must determine the key objective data points that will most heavily influence the decision-making process—say, the cost of goods needed to produce the product, the advertising budget, or estimated numeric values for the potential increase in sales or yields from implementing a new piece of business equipment—or all three plus other objective data points.

An example of a subjective data points might deal with the attitudes of the employees and how much the decision might affect them. It is nearly impossible to assign a numeric value to “attitudes” but it should still be taken into consideration. With insight and thought, a good executive might be able to assign estimated value to productivity. Gauging the direction of the attitude swing of employees might be tricky but could be expressed along the lines of, “This could cost 2 points in gross margin in lost productivity for 6 months while implementing the new piece of business equipment.”

When the executive has the objective and subjective data points in hand, he needs to develop a financial business model that will generate various scenarios that will help predict the outcome of the decision.

Avoid the Temptation to Force a Predicted Outcome

Avoid the temptation of using a financial business model with only the set of variables that provides the outcome that you want predicted. A financial business model should be designed to analyze a series of differing scenarios—each built from the same data points and variables—and to deliver various and accurate outcomes. With potential outcomes in hand, an executive can make an educated decision that will provide the best result for the company.

An executive needs to keep an open mind during the process of running the financial business model—the results often run counter to expectations or to the outcome the executive has played out in his own mind. When this happens, there may be the temptation to dismiss the results. The executive may also be tempted to run the model over and over, changing various data points until the model delivers the desired outcome. This is behavior that can have dire consequences. Instead, evaluate what the financial business model is telling you about the business decision and learn why the financial business model produced a different outcome from your prediction.

Compare the Predicted Financial Business Model's Outcome to the Actual Outcome

After the financial business model has projected the results of several scenarios, the executive needs to choose the most advantageous route and move forward. When enough time has lapsed so that the plan has been implemented and has yielded actual results, the executive should evaluate the effectiveness of the model to determine what was right with the financial business model and what assumptions related to the various data points needs to be revised the next time the financial business model is needed. The executive might find that there were data points that need to be added to the model for consideration or the basis to several of the estimates need to be refined. During the review process, if everything worked out well, the executive will discover that a financial business model actually did help predict the desired outcome.

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