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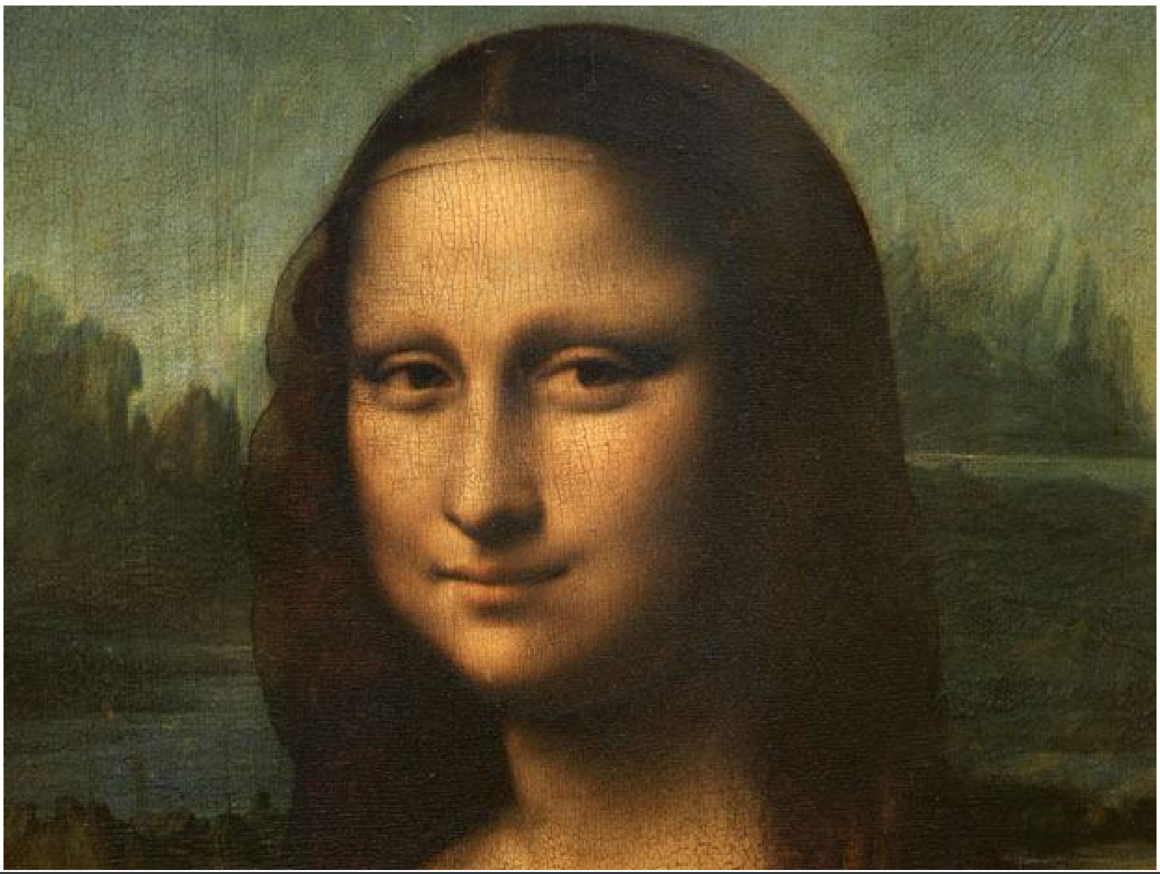
2011: The Year
of the Entrepreneur

Business models let you predict the present



Jean-Pierre Muller/AFP/Getty Images

If you scraped off the paint from Michaelangelo's Mona Lisa, you would likely see the pencil lines that guided the artists' inspirational brush strokes. That's not a bad thing.

Brad Cherniak, Financial Post · Jul. 12, 2011 | **Last Updated: Jul. 12, 2011 10:33 AM ET**

If you scraped off the paint from a Renaissance masterpiece, say Michaelangelo's Mona Lisa, you would likely see the pencil or charcoal lines that guided the artists' inspirational brush strokes. Some would say this cheapens the artistry. I think it is a practical way to ensure a beautiful outcome.

For small to mid-sized business, financial models, if done right, can help guide a similarly beautiful outcome.

Business plans and financial models are the most misunderstood tools in an entrepreneur's toolbox. Financial models are very different from, but often confused with, financial forecasts. (The latter are for raising capital or selling your company, not running and growing it.)

If done wrong - which they most often are - models are mere curiosities trotted out only when financings are done, or once in a blue moon when an investor or board member asks for it. Then there is a mad dash to update it, add recent historical results and tweak forecast assumptions. The result is usually fairly rote, formalistic and meaningless.

A financial model is not actually useful for predicting the future. At the risk of sounding like Yogi Berra, it is actually for predicting the present.

Smart entrepreneurs (and investors) run simple, basic models that show how key variables in the business interrelate and what their impact on key outcomes is as defined by them. These financial models should mirror the complexity in the business. When they become too complicated, it is a sign the entrepreneur has become too clever by half. They are probably muddying the water with too obtuse a product or service offering, too complex a pricing model, or simply a bad business that is just too complicated and likely never to generate a profit.

Building the basic model is often eye-opening for the entrepreneur. To begin, you need to contemplate the following:

— What specifically is a meaningful outcome of the whole process of being an entrepreneur? What do you really want? And by the way, personal wealth is a valid and noble goal.

— What are the true drivers of your business to achieve the goals you value? It is harder than it sounds to do this well.

— Then you need to attribute actual costs to the efforts necessary to create and provide your product or service -full input resource costing. Overhead, and barter arrangements and freebies must be factored in. They are still resources that come from somewhere.

The real value of the exercise to build and maintain a model is not to create a brilliant forecasting tool, but rather to test the entrepreneur's internal logic and thinking about the most basic and core parameters of their business. What exactly are they doing today, and should they be doing this? Or should they be doing things differently? These questions are harder to answer than you may think.

A good model is a baseline; over time it will help confirm what the key "dials to turn" are and what their impact on results are. And what a good result actually is.

The model will become the only tangible way to assess the impact of different strategic or tactical decisions over time based on data. It will, and should, be changing continuously, following the data.

None of this is to say that the entrepreneur's instincts are not paramount. The entrepreneur still makes all the calls. The model is the result of his or her instincts and good decision-making, not the cause of them. A good financial model simply makes an entrepreneur and his or her business better over time, without ever having to be an oracle.

But this model is only for the eyes of the entrepreneur and his or her inner circle, if there is one. The inner circle may be comprised of a trusted advisor, a core employee/partner, or an investor with more invested than their money.

But if the model is not created and maintained by the entrepreneur, its use described above is far more limited. The model should be simple and nimble -if it takes hours to tweak or update, it is useless for its core purpose. It could be used as part of the formal reporting package to a board of directors or advisory board, but that risks muddying its core purpose.

Like a great painter, great entrepreneurs have great instincts, but they also use data to inform their instincts and decision-making. More entrepreneurs should do this.

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