



The Two Key Elements Needed to Build Powerful Financial Models



FINANCIALMODELING
INSTITUTE

Introduction: Modeling is a Discipline

A financial model is a critical decision-making tool that allows users to make accurate and informed financial decisions about a company. A financial model needs to serve as a powerful communication tool to clearly and effectively tell the story of a company to decision makers and to stakeholders.

A builder of financial models requires skills in accounting, finance, modeling software (such as spreadsheets) and overall business knowledge in order to effectively forecast a company's financial statements into the future.

1. The Key Attributes of a Model

To achieve the goals set out above, a model needs to be developed with the following attributes:

- a. **Dynamic:** changes to assumptions properly flow through the model
- b. **Flexible:** modular in order to facilitate easy expansion and changes to the model
- c. **Intuitive:** layout/flow mirrors how people think about the business
- d. **Transparent:** easy to follow with no giant formulas or hidden sections
- e. **Printable:** in a clear and easy-to-read format on paper
- f. **Transferable:** built by one person but usable by many

When a model achieves the criteria above, it creates tremendous credibility for the builder and inspires confidence with the reader. A well-designed model needs to work in two ways:

1. **Electronically** - a model must be simple to review / audit / manipulate in a spreadsheet to ensure it can be used as a tool in the decision-making process
2. **In printed format** - many senior executives and other decision makers prefer to review financial analysis on paper or as PDF documents (rather than reviewing a spreadsheet).

2. Model Planning

It is critical to properly plan and design a model before it can be built.

- Whenever a model becomes filled with errors, it is often because the modeler did not properly devise a model plan. A model built without forethought is often chaotic and requires many additions on a weak foundation.

A model builder needs to first understand how a business operates, which requires:

- Reviewing the historical financial statements of the company (including the Management Discussion & Analysis and Notes to the Financial Statements).
- Learning about the industry in which the company operates (i.e reading industry journals and equity research reports).
- Deciding on the key drivers / critical success factors for the industry / company.
- Creating a list of questions to help identify and gather all the assumptions that need to be made in the model.

Understand the purpose of the model (i.e is the model to be used for valuation?

Credit assessment? Project evaluation?)

Identify the required schedules and components to be included in the model.

- Schedules should be planned for all specific calculations needed in the model, such as revenues, costs, depreciation, working capital, etc.
- Take some time to map out these components and model flow, the same way you would when creating and outline for a presentation. Create a skeleton of your model.

As part of the planning process, the model builder should also be able to answer the following questions:

- Can a reader of the model understand the operations of the company?
- Have the operations been modeled correctly?
- What is the right level of detail required in the model?
- Have the assumptions been challenged and vetted?
- Which assumptions are key drivers to be tested as scenarios?
- Is there enough historical detail to validate the required amount of forecast detail?
- What is the important output that the users want to know?
- What metric is used to measure results?
- How many time periods should be included in the forecast? Why?
- What's the appropriate periodicity for the model (e.g monthly, quarterly, annual)?
- What is the most logical order to present the data?





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