# The Two Key Elements Needed to Build Powerful Financial Models

FINANCIAL MODELING 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 ther 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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