Guide to Financial Models - for Business Owners

What is a financial model?

It's a forecast usually prepared using MS Excel because of its flexibility. It's a decision support tool that provides a view of how your business is predicted to perform in the future. It can never be relied upon to be perfectly accurate as, however well-constructed, a model is only as good as the inputs and assumptions on which it's built.

Why do you need a financial model?

This should be the easy part but you need to be clear on what the purpose of the model is, as that will help frame how it's put together. You usually need it

- As part of an equity fundraising process
- To support a loan application
- To create a budget to measure actual performance against
- To value your business

The 6 steps to build a model

The reality is, unless this is your day job, you won't build it but you'll employ a financial modeler to do it for you. However, you will have a big part to play in it, as you're the one who knows your business and that's what the model needs to reflect.

Step 1: Define the model **purpose** (why you need it), the **time period** it covers (e.g. 3 years), and what it needs to tell you (the **outputs,** e.g. how much you need to raise to keep you going for the next 12 months). Who: You

Step 2: If your business has been trading let the modeler have **access** to your **financial data**. If not, any supporting information such as investor decks. Who: You

Step 3: Brain dump time: the modeler needs to know everything about your business. Who: You

What	Outline	Key factors
Revenue	Who, how, what, where	Products/services, markets, customers, channels, seasonality, marketing and promotions, dependencies, discounting
Variable costs	Who, how, what, where	% relationship to sales, customer support model, suppliers by market, volume discounts, dependencies
Overheads	What, where, when	Staff by function, other staff costs & benefits, premises, insurance, marketing, travel, IT & software expenses, professional fees, office expenses
Capital expenditure	What, why, when	Plant & equipment for production and support, office furniture & equipment, IT spend per person
Working capital	How long sales to cash	How much stock held, how long customers take to pay, how long you take to pay suppliers
Funding	What, how much	Split of debt and equity, the terms of the debt

Step 4: Identify your **assumptions and the key inputs** that drive the calculations in the model and the **scenarios** you want to be modelled. Who: Modeler and you

Assumptions/key inputs:

There are what you use to build the calculations in your forecast, such as sales price per unit, order processing time, production time per unit, materials cost, leads per marketing spend, conversion rates, salaries by function, sales growth %, tax rates, inflation rates, population growth, market size, regulatory changes.

Scenarios:

This is a key part of the model. The '**What if**' that allows you to reflect the uncertainties that are inherent within any business, particularly startups.

There will generally be at least 3 scenarios. How they vary will be defined by yourself and the modeler.

- **Base scenario**: this is your expected result taking all your key assumptions and inputs into account

- **Upside scenario:** A more optimistic view e.g. if sales growth was higher, major customers came on line sooner, or trading started earlier

- **Downside scenario:** Most simplistically the reverse of upside, but there may be specific factors taken into account

Step 5: Build the model. Who: Modeler and you

It's a process of build and review, usually over multiple versions as the model develops. The modeler will be keen to get your review as quickly as possible and as detailed as possible so the number of versions is kept to a minimum.

Step 6: Sense check and **sign off** the model. Who: You

You must be happy that the model is meeting the purpose you defined and that the outputs provide you with everything you need.

What does a good model look like?

Structure: There should be a clear separation between

- **Inputs:** Data that's imported into the model to help drive the calculations

- **Calculations:** Combining the data and assumptions to create the forecast.

- **Outputs:** Summary dashboard and Financial statements

User Guide: There should be a separate worksheet as a user guide to explain the purpose of the model and give an overview of the main worksheets.

Navigation: For larger models a menu with links to the relevant sheets will help user navigation.

Format: Formatting should help the user understand the model better, so e.g. input cells are shaded clearly and consistently. Conditional formatting should be used to highlight errors.

Control sheet: All models contain errors, you just want to find the big ones. A control worksheet helps to do this and links to controls throughout the model, to highlight errors or potential errors.

File protection: To avoid user error. Protect key worksheets and cells such as calculations.

Assumptions and scenarios: They should be on a separate worksheet to allow you to modify them and run the different scenarios within the model.

Outputs: A 3 way financial model will include

- Income statement
- Balance sheet
- Cash flow

It will often include a dash board that includes relevant graphs and charts, and Key Performance Indicators (KPIs) that have been agreed with you, that help user understanding of the model.

How much does a financial model cost?

As you'd expect there's no simple answer to this. There's a number of variables, most obviously the complexity of the model and the experience of the modeler you engage. It also depends on what you want – the gold plated version, the scaled down version, or something in between. You'll always be working with a budget so you'll have to be clear on what's important for you in the model and what you can compromise on.

Freelance modelers will work across a range of day rates, as a guide between £400 and £1,000. Accountancy firms and consultants will charge significantly more.

If you can, agree a fixed price at the start of the engagement.

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Paul Campbell is a Chartered Accountant and director of Cab digital accountants.
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