

# Financial Modeling Best Practices



## IN THIS ARTICLE

- What is a Financial Model?
- 6 Types of Financial Models
- How To Make a Good Financial Model?
- Financial Modeling Best Practices
- Best Financial Modeling Software
- Why Financial Modeling is Important for Your Organization?

Modelling is an essential part of running a business. It allows you to see how different decisions will impact your bottom line and helps you make informed choices about the future of your company.

But financial modeling can be tricky - if you don't do it correctly, you could end up with inaccurate results.

Let's look at what financial modeling is, why it's important for your company, types of financial models, how to create a good one, best practices, and more.

# What is a Financial Model?

A financial model is a tool that can be used to predict the future financial performance of a company.

Financial models are typically used in business planning and decision-making, to assess the feasibility of new projects, or to evaluate the potential return on investment of an existing one.

Financial models are often used in conjunction with other analytical tools, such as market analysis and competitive intelligence, to give a complete picture of a company's financial situation.

There are many different types of financial models, but all share some common features. A good financial model will be:

- **Accurate:** The model should be based on sound assumptions and accurately reflect the data.
- **Relevant:** The model should be relevant to the decision at hand.
- **Flexible:** The model should be flexible enough to accommodate different scenarios and what-if analysis.
- **Understandable:** The model should be easy to understand and explain to others.

## 6 Types of Financial Models

Six of the most often used types of financial forecasting models are:

### 1. Discounted Cash Flow Model

The discounted cash flow (DCF) model is a kind of financial model that values a company by forecasting future cash flows and discounting them back to present value.

The DCF model is a widely used valuation technique, but it has several disadvantages. The model is based on a number of assumptions, such as the discount rate, the length of the forecast period, and the company's terminal value.

These assumptions can have a significant impact on the model's results.

The DCF model only considers cash flows that are expected to be received in the future. This means that it does not take into account other important factors, such as earnings, dividends, or the value of assets.

The DCF model can be difficult to understand and interpret. This is because it relies on a complex formula that discounts cash flows over time.

The DCF model can be time-consuming and expensive to build. This is because it requires detailed financial information and a lot of data to be inputted into the model.

## 2. **Comparative Company Analysis Model**

The comparative company analysis (CCA) model is a type of financial model that values a company by comparing it to similar companies in the same industry.

The CCA model is a relatively simple valuation technique, but it has several disadvantages. The model is based on a number of assumptions, such as the size of the companies being compared, the similarity of their businesses, and the availability of data.

These assumptions can have a significant impact on the model's results.

The CCA model only considers financial information that is publicly available. This means that it does not take into account important factors such as earnings, dividends, or the value of assets.

Like the DCF, the CCA model can be difficult to understand and interpret. This is because it relies on a complex formula that compares companies in different industries.

## 3. **Sum-of-the-Parts Model**

In a sum-of-the-parts model, the value of a company is the sum of the values of its individual business units. This type of model is commonly

used to value conglomerates, which are companies that own a portfolio of businesses in different industries.

To build a sum-of-the-parts model, you will need to estimate the fair value of each business unit and then sum up these values to arrive at the total value for the company.

#### 4. **Leveraged Buy Out (LBO) Model**

An LBO model is a tool used by private equity firms and investment banks to help them analyze leveraged buyout transactions.

Leveraged buyouts occur when a company is purchased using debt as well as equity. The use of leverage (debt) in an LBO increases the risk of the transaction, but it can also increase the potential return.

An LBO model is typically used to help assess the feasibility of a leveraged buyout transaction and to evaluate the potential return on investment.

The model will take into account the amount of debt used in the transaction, the interest rate on that debt, the expected repayment schedule, and the projected cash flow of the target company.

It is important to note that an LBO model is only as good as the assumptions that go into it. The model should be constantly updated and revised as new information becomes available.

#### 5. **Merger & Acquisition (M&A) Model**

One of the most popular types of financial models is the merger and acquisition (M&A) model.

An M&A model is used to estimate the value of a target company in an acquisition scenario. The model is also used by investment banks to win new M&A business.

There are different ways to build an M&A model, but the key inputs are usually the same. These include:

- Purchase price
- Synergies
- Target company's stand-alone value
- Financing mix
- Interest rates
- Tax rate

The purchase price is typically the starting point for an M&A model. This is the price that the acquirer is willing to pay for the target company.

The next key input is synergies. Synergies are the cost savings or revenue increases that can be achieved by combining the two companies. They are typically one of the main reasons for doing an acquisition.

The target company's stand-alone value is the value of the company if it were not being acquired. This is estimated using a discounted cash flow (DCF) model.

The financing mix is the mix of debt and equity that will be used to finance the acquisition. The interest rate is the cost of borrowing for the acquirer.

The tax rate is the percentage of income that will be paid in taxes. This is a key input because it affects the after-tax return on investment for the acquirer.

After all of these inputs have been estimated, the M&A model will generate a value for the target company. This value can be compared to the purchase price to see if the acquisition makes sense from a financial perspective.

## 6. **Option Pricing Model**

Option pricing models are mathematical models that are used to determine the theoretical value of an option. These models take into account factors such as the underlying asset's price, volatility, time to expiration, and interest rates.

The most popular option pricing model is the Black-Scholes model. This model was first published in 1973 by Fischer Black and Myron Scholes.

Other option pricing models include the Binomial model and the Trigeorgis model.

Option pricing models are used by traders to determine the best time to buy or sell an option. They are also used by investors to determine whether an option is fairly priced.

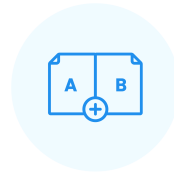
## Common Types of Financial Models



Discounted Cash Flow Model



Comparative Company Analysis Model



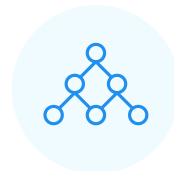
Sum-of-the-Parts Model



Leveraged Buy Out (LBO) Model



Merger & Acquisition (M&A) Model



Option Pricing Model

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## How To Make a Good Financial Model

A good financial model needs to be easy and efficient to use, review and understand. To benefit the company it needs to create insights and outputs that are relevant and actionable for the company. Here are some steps to help ensure you are creating a good financial model.

### • Start by Building a Model That Is Simple and Easy To Understand

A good financial model is one that is simple and easy to understand. The best way to achieve this is to start by building a model that is easy to follow. A good rule of thumb is to build the entire model from scratch, so that you can see how each piece fits together.

This will help you understand the relationships between the different elements of the model, and how they all work together.

A good financial model includes the following sections: assumptions and drivers, income, balance sheet, and cash flow statement. It should also include supporting schedules and sensitivity analysis. You can also include graphs and charts to visually represent the results of your model.

Financial models are vital tools used by professionals in a variety of industries. For example, bankers use them to conduct due diligence and valuations. They can also be used for portfolio management.

A financial model should also be dynamic. It should consider the relationships between the relevant factors. It shouldn't assume a perpetual growth rate higher than the GDP of the domestic country.

## • **Use Assumptions That Are Realistic and Conservative**

When you're model building, to get the most accurate information, always use conservative, realistic assumptions. If your assumptions are too far away from the most likely scenarios, then the model data won't be useful.

Financial models should reflect key business assumptions in a clear, concise, and defensible manner. They should also reflect projected performance in a way that is easily understandable and flexible.

Using assumptions that are conservative and realistic is crucial in making a financial model that can be trusted.

## • **Make Sure Your Inputs and Outputs Are Clearly Labeled**

Clearly labeling inputs and outputs is crucial to keeping data consistent. Ideally, you'll structure your model so that you only have to enter the data once. Start with historical data, such as income statements and other financial statements.

To make it easier to understand the difference between your inputs and

outputs, use a consistent color coding system. For example:

- **Blue:** Assumptions, inputs, and drivers
- **Black:** Formulas and calculations with references to the same worksheet
- **Green:** Calculations and references to other Excel spreadsheets
- **Red:** References to separate files or external links

*Taking a financial modeling course can help you ensure you build quality models to analyze various scenarios.*

## Financial Modeling Best Practices

Building a financial model can be tricky, below are a few best practices to follow to ensure your models are accurate, insightful, and usable.

### • Clarify the Problem and Set the Goal

A financial model should not contain the same assumptions or data twice, and it should be consistent from sheet to sheet. Changing an assumption should automatically change outputs throughout the entire sheet.

For example, a bakery that wants to buy a candy company may use a complex merger financial model to justify the price of the new combined entity.

Another example might be a company looking to pitch to investors and needs to show its economy of scale and growth.

Regardless of how complex the model is, its key components should be simple and easy to understand. Modeling is a process, and it should be done as efficiently and accurately as possible.

For best results, the process should be iterative. This is because mistakes and omissions can occur during model building.

## • **Keep the Model as Simple as You Can**

Use simple language and avoid confusing technical terms. The basic structure of a financial model will contain inputs, processing methods, and outputs. The model should also have a table of contents that can guide users through the model.

In a spreadsheet, it is advisable to use a single formula per row. This means that the formula in the first cell of each row should be the same as the formula in the rest of the row.

In this way, users will be able to understand the structure of the model. Although this may seem obvious, this practice is often violated. For example, spreadsheets often have multiple rows, and different formulas for each column.

The purpose of financial modeling is to forecast the financial performance of a business. It is an analytical process based on historical performance and assumptions about future revenue and expenses. It is a tool that helps operators of a business make data-oriented decisions.

## • **Plan the Model Structure**

Many big companies and investment banks use Microsoft Excel to plan their financial models. Make sure you color code your cells, set up error checks, conditional formatting and data validation, follow a consistent row and column structure, and use one formula per line.

Financial models should be easy to read. The formulas should be easily understood by non-modelers. Use colors such as blue for constants in the model, and green for cross-references among different sheets.

You should also plan the presentation of your financial model. This way, you can ensure that others will understand it easily.

## • **Use Accurate Data and Protect Its Integrity**

Every model needs accurate data - and using Planergy for spend analysis can ensure you have the correct spend data to begin with. If you have

inaccurate data, you'll get poor quality insights.

## • Use Dummy or Test Data

Before implementing your model for decision-making, start with test or dummy data to put the system through a stress test. When you know it works, move it to active use with current data.

## Financial Modeling Best Practices



Clarify the Problem  
and Set the Goal



Keep the Model as  
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Plan the  
Model Structure



Use Accurate Data and  
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Test With  
Dummy Data

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## Best Financial Modeling Software

There are many options when it comes to financial modeling software. The best choice for your company will depend on the features and level of support you need. Here is a list of some of the best options.

### • Finmark

Finmark offers flexible financial modeling software that is easy to use. It is great for startups and established companies alike, and it can help users build and manage custom models.

It allows users to create and compare multiple scenarios and track

important metrics such as revenue and expenses. It also offers customizable formulas and reusable variables.

## ▪ **Excel**

Excel is a powerful financial modeling tool but it has its own limitations. It can be difficult to handle multiple projects at once. Excel requires skilled programmers to manage the workflow. Many Excel users end up with jumbled spreadsheets.

Moreover, Excel has serious limitations when it comes to the accuracy of a financial model. Using an Excel-based financial model has cost companies billions of dollars. There are good reasons for finance teams love/hate relationship with Excel.

## ▪ **Jirav**

Jirav can help streamline the process of budgeting, forecasting, and reporting. It also allows users to make adjustments and automatically roll forward their plans.

Jirav's cloud-based financial planning and analysis software also allows users to work with consolidated data. Jirav also improves the security and collaboration of planning and analysis.

## ▪ **Cube**

Cube is a great solution for small to mid-size businesses. Cube's simplified interface makes it easy to use and is a good choice for those who have had experience with spreadsheets. It also provides enterprise-grade technology at a reasonable price.

You can even integrate Cube with Google Sheets, which further reduces the learning curve.

# Why Financial Modeling is Important for Your Organization

Financial modeling is important for your organization because it:

- Helps you make informed decisions about the future of your company.
- Allows you to see how different decisions will impact your bottom line.
- Helps you assess the feasibility of new projects.
- Evaluates the potential return on investment of an existing project.
- Gives you a complete picture of your company's financial situation.

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