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What is Financial Modelling?

What is financial modelling? Why are we all here and what are we trying to learn?

I think a lot of people have got some pretty complicated ideas about what a financial model is. A financial model can be terribly, terribly complicated but it can be simple as well and I'm going to try to simplify it as much as possible.

I'm going to let you in on a little bit of a secret but you must promise not to tell anybody. Have we got a deal? Okay really all it is, is just a big spreadsheet. That's all a financial model is.

The idea is that it's a structure, a model in Excel. It's nearly always in Excel. It doesn't necessarily have to be in Excel but we're nearly always using Excel for the purpose of financial modelling nowadays. It's a structure, it contains input and it contains outputs. Really that's all a financial model is. You may not necessarily call yourself a financial modeller but if you're using Excel for the purpose of finance or analysis and you're in Excel and you've got input and you've got outputs. You change the inputs and the outputs change, then that's a financial model.

Not everything you do in Excel though you can call a financial model. You'll notice in this course I don't use the word spreadsheet very much. I find it's a fairly basic term. I much prefer to call it a financial model because it sounds so much more professional. Don't you think that if you go to your boss and you say "let me just refer to my financial model" or "I'm just going to look it up on the spreadsheet." Calling it a financial model makes it sound so much more professional, so we're going to call it a model as much as we possibly can.

Introduction to Financial Modelling in Excel

But not everything you do in Excel you can call a financial model. There's a few slight differences between a spreadsheet and a financial model. A spreadsheet is a catch all term. It could be anything containing data.

A financial model is more structured. The structure of a financial model is that you have assumptions, inputs, outputs, calculations and scenarios. Basically the structure of a financial model is that you work from left and you go over to the right. We usually start with the inputs at the back, so when you open up in Excel. You open up and you look at sheet one and that's your output and so your detail will be at the back, you're calculations in the middle and your output at the front. That's typically a structure for a financial model.

A financial model is more dynamic. If you just have a list of telephone numbers for example, that's not a financial model. Anything that contains formulas, it's dynamic. The definition of a financial model is that it must be dynamic. If you have inputs and you have outputs, you can then call it a financial model.

A model uses relationships between variables, so when you change that input, the outputs will change. This is a really important point of best practice in financial modelling. It's so that when you change the inputs, the outputs will change as well. A financial model always contains some types of hypothetical outcomes or the capacity at least to have some hypothetical outcomes. That's a really big part of financial modelling. Having the capacity to put scenarios and sensitivity analysis into your model is a very important part of financial modelling.

In summary, a financial model is a structure in Excel that has inputs, it has outputs, it's dynamic and it contains hypothetical outcomes.