Ten things you need to know about finance

Ian Marcousé provides a framework of ten key concepts to aid your revision

1 Breakeven

At breakeven all costs are covered by the revenue generated.

Formula: $\frac{\text{Fixed costs}}{\text{Contribution per unit}}$

Example: a business with £40,000 of fixed costs, a £6 selling price and a £4 variable cost per unit has a breakeven point of 20,000 units.

Advantage: shows the minimum sales level needed to avoid making losses.

Disadvantage: may flatter to deceive — breaking even may be quite easy, but the real test of business sustainability is profit.

2 Cash is king

For new firms, fast-growing firms and in recessions, cash is more important to a business than profit.

Example: camera retailer Jessops went into administration in January 2013 because it was no longer able to pay its bills, i.e. there was a shortage of cash.

Advantage: the tougher things get for a company, the greater the pressure on cash (suppliers refuse to give credit, bankers get fussier about overdraft limits etc.), so it becomes the top priority.

Disadvantage: in the long term, profit generates the finance for expansion and renewal. Cash is king only in the short term.

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3 Contribution

The amount contributed by sales towards covering fixed costs. This can be measured per unit of sale (contribution per unit) or as total contribution (quantity sold × contribution per unit).

Example: if a business sells 200 units at £3 each, with variable costs of £1 per unit, the contribution per unit is £2 and total contribution is £400.

Advantage: contribution is used widely in business decision making, for example in breakeven analysis, in pricing decisions and in decisions about whether or not to outsource production.

Disadvantage: as contribution ignores fixed costs, there is a risk that decisions could be made (on pricing for example) that under-provide for fixed costs, leading to losses.

4 Costs

The breakdown of costs into fixed and variable provides businesses with crucial information for decision making. Variable costs vary in direct relation to output; fixed costs do not change when output changes.

Example: if a business has 50p of variable costs per unit and £500 of fixed costs, sales of 2,000 units will generate total costs of £1,500.

Advantage: by calculating total costs it is possible to quickly estimate possible profits. Breaking the costs into two parts helps identify both the gross and the net profit from a business decision.

Disadvantage: the breakdown into fixed and variable is a bit of a simplification. There can be semi-variable costs that act as a hybrid: part fixed and part variable.

5 Costs per unit

Total costs divided by the number of units sold gives cost per unit (a.k.a. unit costs). This is not the same as variable costs because unit costs include the fixed costs shared out among the units sold.

Example: if variable costs per unit are £4, fixed costs are £4,000 and sales are 2,000 units, the cost per unit is £6 (£12,000/2,000).

Advantage: unit costs can be compared with selling price to measure profit per unit.

Disadvantage: unit costs involve averaging the cost data. This can create distortions.

6 Financing by debt

For any business, equity capital represents security while loan capital involves risk. Debt-financed growth leaves a business vulnerable if difficult trading is made worse by high repayment bills plus the need to repay the capital.

Example: a new business might be funded with 50% share (equity) capital, 30% long-term loans and 20% overdraft. This means 50% is funded by debt, which is riskily high.

Advantage: if the business proves highly profitable it is good to only have to pay bankers rather than spread the profits around many shareholders.

Disadvantage: every business hits bad patches, especially new ones, so it is irresponsible to be overly dependent on debt that needs to be serviced and repaid.

7 Private equity

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A form of venture (risk) capital that is usually based on a high level of debt. This is intended to force managers to be as lean as possible, i.e. high pressure to meet the huge interest payments on the debt.

Example: since the Glazer family made Manchester United Football Club private (previously it had been a plc), the club has had to pay more than £400 million in interest charges on the £525 million of debt that the Glazers loaded onto its balance sheet.

Advantage: supporters of private equity say that it is a way to squeeze the most out of management and staff to achieve higher performance.

Disadvantage: critics believe that the risks involved in private equity are one-sided: heads and the owners win, tails and the staff lose.

8 Profitability

Measuring profit in relative terms, e.g. in relation to last year's profit or in relation to sales revenue.

Example: while many commentators praised Sainsbury's in early 2013 for taking market share from Tesco, the *Daily Telegraph* criticised the grocery retailer for having a net profit margin of just 3.4%.

Advantage: profitability is the right way to measure (a) the effectiveness of a firm's strategy and (b) whether the business is being pulled in the right direction.

Disadvantage: high profitability might mean little if the business is struggling to achieve the sales level that gives it recognition in the marketplace.

9 Profit vs cash

Profit shows the medium-to-long-term effect of a financial transaction whereas cash flow shows the immediate effect on a firm's bank balance.

Example: selling £1 million of property for cash will boost the bank balance by £1 million, but may lessen the firm's ability to make profits in the longer term.

Advantage: forecasting the impact of a deal on both profit and cash flow ensures that the business understands the short-term and longer-term impacts on the firm's finances.

Disadvantage: the inputs determining profit and cash flow are the same, therefore both are affected by a problem such as an unhappy customer who is unwilling to pay a bill.

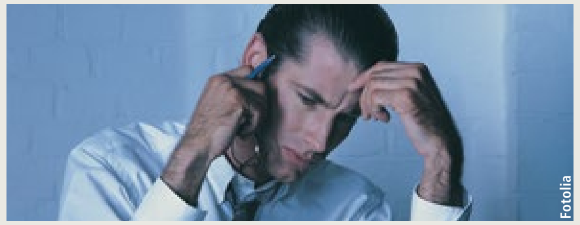
10 Uncertainty

With every financial technique it is important to remember that things can go wrong for reasons out of your control. Uncertainty leads to the risk that positive expectations may end in disappointment.

Example: an entrepreneur making revenue forecasts for a new business should be cautious, in the hope that errors will be on the upside not the downside. In the same way, cost forecasts should be pessimistic on the upside.

Advantage: caution in forecasting should help in beating budgets, which will impress bankers and investors.

Disadvantage: the inherent optimism of the entrepreneur sometimes means that even the 'pessimistic' allowance for uncertainty proves insufficient.



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