The key elements of the financial plan essay sample

Finance

One of the fundamental tools used in managing account, profit forecasting and pricing strategies is definitely the “ break-even analysis”, that can be defined as “ a technique for analysing how revenue, expenses and profit vary with changes in sales volume or simply it is the analysis that enables any professional organisation to determine the break-even point”. The “ break-even point” or BEP can be considered as “ the point (level of production) in which a company generates the same amount of revenues and expenses during an accounting period (Revenues = Total costs). No profit and no loss have incurred. Since revenues equal expenses, the net income is zero. The company did not lose money, but it also did not gain any money either. It simply broke even during that period”

When computing the break-even analysis several pieces of information (variables) are needed:

– Direct/indirect expenses;

– Fixed/variable costs (considering that fixed costs incur even if there is a “ zero” production);

– Selling price and contribution margin per unit;

– Sales revenues.

The “ contribution margin” can be defined as “ the selling price minus the variable cost, resulting in the incremental profit earned for each unit sold. The total contribution margin is the difference between a company’s total sales revenue and total variable costs. This difference represents the total earnings that can be used to, or contribute to, pay off fixed costs and to generate a profit”

(Definition took from https://www. accountingtools.

com/articles/2017/5/16/contribution-margin).

The “ contribution margin” can be calculated for (as explained in our workbook):

– Individual products:

Selling Price per Unit – Total variable costs per unit = Contribution Margin per Unit;

– Product Lines/Profit Centre:

Total Sales Revenue – Total Variable costs = Total Contribution Margin.

It can also be calculated as a percentage of Sales (C/S Ratio)

– Per Unit:

Contribution Margin per Unit X 100

Selling Price per Unit

– Per total Revenue:

Contribution Margin per Unit X 100

Sales Revenue

“ Considering that the break-even point shows when a company’s revenue equals total fixed costs plus variable costs, and its fixed costs equal the contribution margin”, it can be calculated with the following formulas:

– Break-even Point (volume/unit) = Fixed Costs

Contribution Margin Unit

“ It calculates the number of units that need to be produced/sold in a period in order to make enough money to cover costs”;

– Break-even Point (Sales/Revenue) = Fixed Cost

C/S Ratio

“ Dividing the fixed costs by the contribution margin ratio for a specific period, it enables to calculate the actual sales (revenue needed to recover costs)”.

As any other professional organisation, hotels have as main objective achieving a certain level of profitability or return on investment and the break-even analysis enables hotel managers to establish how much of any product (Guestrooms, Food & Beverage items, etc.) or service (laundry services, concierge service, etc.) must be sold in order to realise a profit (exact point above which they need to operate to ensure a profit).

Furthermore, the break-even analysis assists hotel management with the pricing of their products, services, menu prices and room rates, again keeping in mind the achievement of profit.

Total sales = Total costs = Zero Profit

Total sales higher Total costs = Profit

Total sales lower Total costs = Loss

To make the Break-even Point importance clearer, I am reporting below an example (that was discussed during the course) of a restaurant with an average selling price of £20 per meal, Food cost is 30% of selling price,

Labour cost is 20% of selling price, the direct expenses are £0. 75 per meal, maximum capacity is 1000 meals per week and fixed cost is £5, 400 per week.

– Selling Price per meal £20

– Food (30% of £20) £6 (20 X 0. 30)

– Labour (20% of £20) £4 (20 X 0. 20)

– Direct Expenses £0. 75 per meal

– Variable Costs per meal = Food + Labour + Direct Expenses = £6 + £4 + £0. 75 = £10. 75

– Total Variable Cost = Variable costs per meal X maximum capacity = £10. 75 X 1000 = £10, 750

– Total Costs = Total Variable Costs + Total Fixed Costs = £10, 750 + £5, 400 = £16, 150

– Maximum Revenue = Selling Price X Maximum Capacity = £20 X 1000 = £20, 000

Contribution Margin per Unit = Selling price – Variable costs per meal = £20 – £10. 75 = £9. 25

Break-even Point (in volume/units) = Fixed Costs : Contribution Margin per Unit = £5, 400 : £9. 25 = 584

Break – even Point (in revenue/sales) = BEP in units X selling price = 584 X £20 = £11, 680

Therefore, considering a weekly operation of this restaurant that has a maximum capacity of 1000 meals and a maximum revenue of £20, 000, it

will be needed to sell 584 meals and generate a revenue of £11, 680 in order to break-even (See graph).

In conclusion, managers must understand that the break-even point has a strong influence on the economic feasibility of a project. Having a low break-even point makes the selling of a service/product a more economically doable project. Lowering the break-even point is possible by raising prices or cutting costs (both fixed and variable).