

IO1 – A5

FCT Course Development Cash Flow Tools



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TITLE
1. PRO-FORMA FINANCIAL STATEMENTS
ABSTRACT
Financial statements projecting the business operations in upcoming years. A convenient and easily understood means of summarizing much of the relevant information of the business, pro forma financial statements rely on cash flows developed on the basis of a set of estimates. They are an essential educational and predictive financial management tool for entrepreneurs.
GENERAL DESCRIPTION OF THE SPECIFIC ACTION
<p>Through pro-forma financial statements investors acquire better insight on operating results of a company. They can help assess future prospects of a company. The idea is to write down a sequence of financial statements that represent expectations of what the results of actions and policies will be on the financial status of the company in the future. It should be used before big financial decisions: debt refinance, one-time events, leases, company mergers or purchases. Pro-forma financial statements are also valuable in external reporting. Budget may also be considered as variation of pro forma financial statement. It is possible to manipulate with pro forma financial statements, so it is important to compare them to generally accepted accounting principles, standards and procedures. In some industries, like telecom companies, pro forma financial statements project much more precise financial performance.</p> <p>In essence, pro forma financial statements rely on “hypothetical budgeting”, whereas they look and predict budget changes based on various factors, taking into account both the best and the worst case scenario. They are prepared in advance of a planned transaction, so they are “forward-looking”. They are especially important for startups as they allow entrepreneurs to go mentally through each step of the budgeting process in advance and think thoroughly about possible hurdles that may hinder their progress.</p> <p>Several examples of pro forma financial statements include: full-year pro forma projection, investment pro forma projection, historical with acquisition, risk analysis, adjustments to GAAP (generally accepted accounting principles) or IFRS (International financial reporting standards).</p> <p>Uses of pro forma statements:</p> <ul style="list-style-type: none">- business planning and control- financial modelling- assessing the impact of changes- external reporting- eliminating or minimizing a number of risk factors <p>Based on the current financial situation, the pro-forma financial statements will most likely require the entrepreneurs to make a number of input data assumptions regarding sales and expense growth rates.</p>

Action Type
Actions that have prerequisites (other actions need to be implemented first) and require investment.
Connected Actions
Action 1 - Starting up with Accounting Action 2 - Balance Sheets Action 3 - Cash Flow Statements Action 5 - Profit and Loss
Time required to implement a solution and when possible associated cost
Once you have grasped the intricacies of financial statements you will need at least 4 hours to learn how to project the values in the future. Please reserve at least a week for the entire process to become clear to you. Once it is, there is no going back!
Positive and Negative Part of the Solution
Positive: Once you go through the mental gymnastics of visualizing your company's performance in the future, you will find it much easier to get the big picture as well as anticipate and spot the possible challenges as well as where exactly they might arise. In a way, you have eliminated part of the uncertainty and risk by planning for the future and calibrating your numbers in advance.
Negative: No matter how precise your estimates are, they will inevitably be off the mark in the end as certain discrepancies between the projected and the actual state are bound to arise. That is the price one pays for living in the real world. You will have to get used to the idea that there is no perfect forecasting tool, which should nevertheless not hinder you from using pro-forma statements in order to eliminate as much uncertainty as possible (never all of it, though!)
Estimated Exploitation
Immediate and during each planning and/or investing cycle.
ICT Competence
Intermediate
English Language Skills
Basic, as math is the global language of finance.
Webshop Level
N/A
Informative Text (Sources)

<https://www.lendgenius.com/blog/pro-forma/>

What does pro-forma mean?

Translated from Latin, pro forma literally means “for the sake of form” or “as a matter of form.”

In a business sense, it means assumed, predicted, or forecasted.

Whereas a standard financial statement is based on a company’s past performance, a pro forma financial statement shows what a company’s hopes to earn.

In other words, it’s based on what is predicted to happen.

A small business’s pro forma financial statement can include projected revenue, estimated expenses and costs, and cash flow usually over a three- to five-year period.

Additional Resources

1. Pro-forma financial statements for entrepreneurs

<https://www.mindmeister.com/481116203/pro-forma-financial-statements-for-entrepreneurs>

2. What are pro-forma financial statements?

<https://www.accountingtools.com/articles/what-are-pro-forma-financial-statements.html>

3. How to prepare pro-forma financial statements for a business plan?

<https://www.encyclopedia.com/articles/how-to-prepare-pro-forma-financial-statements-for-a-business-plan/>

4. Forecasting the balance sheet

<https://courses.lumenlearning.com/boundless-finance/chapter/forecasting-the-balance-sheet/>

5. How to prepare pro-forma financial statements?

<https://bizfluent.com/how-2093871-prepare-pro-forma-financial-statements.html>

6. The difference between a budget and a pro-forma financial statement

<https://blog.projectionhub.com/the-difference-between-a-budget-and-pro-forma-financial-statement/>

7. Pro-forma financial statements

<https://www.investopedia.com/walkthrough/corporate-finance/4/capital-investment-decisions/pro-forma.aspx>

Cross Border remark

The International Accounting Standards Board (IASB), an independent international standard setting body in London, issued the International Financial Reporting Standards (IFRS) in 2001 in order to bring transparency, accountability, and efficiency in the global economy.

TITLE
2. NET WORKING CAPITAL
ABSTRACT
<p>In addition to long-term assets, a company needs to plan for investments in net working capital. This is a crucial indicator of the company's short-term liquidity and efficiency. A positive Net Working Capital (NWC) shows that the business has sufficient funds to meet its current financial obligations and invest in future activities. The ability to service their short-term debt is considered crucial for the survival of startups.</p> <p>Simply put, net working capital are the available funds used to cover the immediate and short-term business needs.</p>
GENERAL DESCRIPTION OF THE SPECIFIC ACTION
<p>Net working capital (NWC) is the difference between current assets and its current liabilities. Current assets are the assets that are available within 12 months or within current business cycle while current liabilities are the liabilities that are due within 12 months or within current business cycle. Current assets include the following: cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses and other liquid assets that can be easily converted to cash. Current liabilities include short-term debts, accounts payable, accrued liabilities and other similar debts.</p> <p>Net working capital measures operational efficiency, liquidity and short-term financial health. It is more revealing when tracked on trend line for longer period of time. In a healthy company it should be positive, which signals that company may have enough cash to rapidly grow the business or in case of unexpected expenses to cover up the debt. High working capital is not always considered a good thing, because sometimes it could signal that company is not investing surplus of cash or has too much inventory.</p> <p>Even with a positive net working capital, a company could still intermittently experience a cash flow gap.</p> <p>A project will usually demand investment in net working capital which will be retrieved towards the end of the project. Because of that investment in project net working capital closely resembles a loan.</p>
Action Type
<p>Actions that have prerequisites (other actions need to be implemented first), but require no investment.</p>
Connected Actions

Action 2 - Balance Sheets Action 3 - Cash Flow Statements Action 5 - Profit and Loss
Time required to implement a solution and when possible associated cost
Once you have acquired the necessary knowledge from the connected actions, you will be able to calculate Net Working Capital and understand its importance immediately.
Positive and Negative Part of the Solution
<p>Positive:</p> <p>Working capital indicates how well you positioned your company to service its short-term obligations. Two advantages of NWC are as follows:</p> <ul style="list-style-type: none"> • Speed: Easy to calculate and, if eligible, relatively quick to secure financing through short-term loans, accounts receivable credit lines, inventory loans and bank loans. The loan amounts are typically a fraction of revenues and are tied to assets that quickly convert to cash. • Flexibility: NWC financing is generally flexible, with varying interest rates and repayment terms, which can greatly aid companies with seasonal fluctuations to smooth out cash flow. <p>Negative:</p> <p>As straightforward as it seems, net working capital can be very misleading due to the following reasons:</p> <ul style="list-style-type: none"> • Line of credit: If an open credit line is used to service current obligations, NWC will provide misleading information. • Anomalies: Depending on the selected date, NWC may contain a random deviation which can greatly influence the calculated amount. • Liquidity: If Inventory makes up a significant portion of short-term assets, it may significantly lower the true value of NWC
Estimated Exploitation
Immediate and during each planning and/or investing cycle. It also allows for understanding the Net Working Capital ratio used in Fundamental Analysis.
ICT Competence
Intermediate
English Language Skills
Basic English and basic Math

Webshop Level
N/A
Informative Text (Sources)
<p>https://www.accountingtools.com/articles/what-is-net-working-capital.html</p> <p>The amount of net working capital can be altered favorably by engaging in any of the following activities:</p> <ul style="list-style-type: none">• Requiring customers to pay within a shorter period of time. This can be difficult when customers are large and powerful.• Being more active in collecting outstanding accounts receivable, though there is a risk of annoying customers.• Engaging in just-in-time inventory purchases to reduce the inventory investment, though this can increase delivery costs.• Returning unused inventory to suppliers in exchange for a restocking fee.• Extending the number of days before accounts payable are paid, though this will likely annoy suppliers.
Additional Resources
<ol style="list-style-type: none">1. How to calculate net working capital? https://www.behalf.com/customers/working-capital/how-to-calculate-net-working-capital/2. Net working capital https://www.investopedia.com/terms/w/workingcapital.asp3. What is net working capital? https://www.accountingtools.com/articles/what-is-net-working-capital.html4. Net working capital https://www.wallstreetmojo.com/net-working-capital/
Cross Border remark
<p>This is one international measure of liquidity and can be easily used across borders in order to compare different companies' liquidity and efficiency.</p>

TITLE
3. OPERATING CASH FLOW
ABSTRACT
<p>Cash is the lifeblood of any business, without which running day-to-day operations would be impossible. Operating cash flow (OCF) is therefore the cash generated from a company's regular business activities. It indicates whether a company can generate sufficient positive cash flow to remain solvent, or it may require external financing for capital expansion. It is sometimes also called cash flow from operations, cash flow from operating activities, or free cash flow (FCF).</p>
GENERAL DESCRIPTION OF THE SPECIFIC ACTION
<p>Operating cash flow reports if cash inflows from business operations without regard to secondary sources of revenue are sufficient to cover its everyday cash outflows. Operating cash flow is a cash flow that results from the company's day-to-day activities of business operations. Operating cash flow concentrates on cash inflows and outflows related to a company's main business activities, such Actions that have prerequisites (other actions need to be implemented first), but require no investment. as selling and purchasing inventory, providing services, and paying salaries. Any investing and financing transactions are excluded from operating cash flows and reported separately, such as borrowing, buying capital equipment, and making dividend payments. In essence, free cash flow represents the cash version of a company's net income and can be found in the Cash Flow Statement.</p> <p>During the startup phase of the business, it is normal to see negative operating cash flows. At the growth and later stages, operating cash flows become positive as free cash flows are released that can be used to fund new business lines or simply go back to their investors.</p> <p>The easiest way to calculate Operating Cash Flows is by adding Earnings Before Income, Changes in Working Capital, and Taxes (EBIT) to Depreciation and then subtracting Taxes from that figure. Investors prefer analysing cash flows because they are not easily manipulated. Investors are searching for companies that have high or increasing operating cash flow but low share prices which often soon leads to increase in share prices.</p> <p>Many business owners mistakenly interchange the metrics of net income with operating cash flow. The major difference between the two is a company's required investment in working capital. This will have a significant impact on operating cash flows.</p>
Action Type
<p>Actions that have prerequisites (other actions need to be implemented first), but require no investment.</p>
Connected Actions
<p>Action 2 – Net Working Capital Action 3 - Cash Flow Statements</p>

Time required to implement a solution and when possible associated cost
Once you have acquired the necessary knowledge from the connected actions, you will be need at least one day to able to calculate Operating Cash Flow and understand its importance, dynamics and context.
Positive and Negative Part of the Solution
<p>Positive:</p> <p>Determining the correct levels of operating cash flows is one of the main ways to assess the overall financial health of the business.</p> <p>Negative:</p> <p>It may be time-consuming to calculate correctly and even then you might have to rely on a number of assumptions which may in turn provide inaccurate figures.</p>
Estimated Exploitation
Immediate and during each planning and/or investing cycle. It also allows for understanding the Net Working Capital ratio used in Fundamental Analysis.
ICT Competence
Intermediate
English Language Skills
Basic English and basic Math
Webshop Level
N/A
Informative Text (Sources)
<p>There are 2 different methods of calculating OCF, direct and indirect.</p> <p>Calculating Cash flow from Operations using direct method includes determining all types of cash transactions including cash receipts, cash payments, cash expenses, cash interest and taxes</p> <p>Calculation of Cash flow from operations using indirect method starts with the Net income and adjust it as per the changes in the balance sheet.</p> <p>https://www.wallstreetmojo.com/cash-flow-from-operations/</p>
Additional Resources
<p>1. What is operating cash flow? https://www.wallstreeoasis.com/finance-dictionary/what-is-operating-cash-flow-OCF</p> <p>2. Operating cash flow https://www.investopedia.com/terms/o/operatingcashflow.asp</p>

3. Operating cash flow

<https://www.myaccountingcourse.com/financial-ratios/operating-cash-flow>

4. Operating cash flow

<https://www.accountingtools.com/articles/2017/5/13/operating-cash-flow>

Cross Border remark

Please consult your national accounting standards to determine if there is a preferred way for calculating the operating cash flow, direct or indirect.

TITLE
4. DISCOUNTED CASH FLOW
ABSTRACT
Discounted cash flow (DCF) is a valuation method estimating the value and attractiveness of an investment opportunity based on the time value of money principle. It establishes the current value of a series of a future cash flows. Discounted cash flow valuations have become an essential part of standard finance methodology, which defines the value of the company as the present value of the company's future free cash flows (FCF), discounted at the weighted average cost of capital (WACC) rate, plus the company's initial cash and marketable securities. Discounted cash flow analyses use future free cash flow projections and discounts them, using a required rate of return. This is the only correct measure to be used when calculating cash flows over time.
GENERAL DESCRIPTION OF THE SPECIFIC ACTION
<p>Discounted cash flow analysis is trying to figure out the value of an investment today, whether they involve real or financial assets, based on projections of how much money it will generate in the future. The idea is that the value of any company is equal to the sum of its future cash flows, discounted to a present value using a relevant rate. It is routinely used by people buying a business. Two basic DCF methods are the net present value and the internal rate of return. Discounted cash flow is as good as its input, since small changes in its inputs can result in huge changes in the estimated value of company, and every assumption has the potential to destroy accuracy of estimation.</p> <p>The time value of money (TVM) principle relies on the assumption that any amount of money is worth more the sooner it is received. This idea draws from the assumption that rational investors prefer to receive money today rather than the same amount of money in the future.</p> <p>Steps in performing discounted cash flow valuation:</p> <ol style="list-style-type: none"> 1. Calculate the free cash flows for all periods under the investment horizon 2. Discount by the WACC 3. Add all the free cash flows for all periods under the investment horizon <p>The discounted cash flow model is so important because of its versatility. It can be used to value a company, a project or investment as part of it, shares of stock and/or bonds as well as anything that may impact the cash flow.</p>
Action Type
Actions that have prerequisites (other actions need to be implemented first), but require no investment.
Connected Actions
Action 2 – Net Working Capital

Action 3 – Cash Flow Statements
Time required to implement a solution and when possible associated cost
Once you have acquired the necessary knowledge from the connected actions, you will be need at least one day to able to calculate Discounted Cash Flow and understand its importance, dynamics and context.
Positive and Negative Part of the Solution
<p>Positive:</p> <p>Provides the closest estimate of the cash flow’s intrinsic value. It isn’t significantly influenced by short-term market conditions or non-economic factors.</p> <p>Negative:</p> <p>Very sensitive to the assumptions being made – even small adjustments can cause great variations if the time horizon is long enough. Moreover, it’s a more time-consuming technique when compared to other valuation methods.</p>
Estimated Exploitation
Once acquired, this technique will very likely become essential whenever you will need to forecast and estimate your company’s operating cash flows in the future. Moreover, it will change the way you think about time preference of money and help you better understand the context of future expectations and how to manage them.
ICT Competence
Intermediate.
English Language Skills
Basic, as this method mainly relies on math.
Webshop Level
N/A
Informative Text (Sources)
<p>6 Steps to Building a DCF Model</p> <p>A discounted cash flow model (“DCF model”) is a type of financial model that values a company by forecasting its’ cash flows and discounting the cash flows to arrive at a current, present value. The DCF has the distinction of being both widely used in academia and in practice. Valuing companies using the DCF is considered a core skill.</p>

<https://www.wallstreetprep.com/knowledge/dcf-model-training-6-steps-building-dcf-model-excel/>

Additional Resources

1. Discounted cash flow

<https://www.investopedia.com/terms/d/dcf.asp>

2. Discounted cash flow Formula Guide

<https://corporatefinanceinstitute.com/resources/knowledge/valuation/dcf-formula-guide/>

3. DCF Valuation

<https://einvestingforbeginners.com/dcf-valuation/>

4. Discounted cash flow Method

<https://www.accountingtools.com/articles/the-discounted-cash-flow-method.html>

Cross Border remark

DCF is a technique universally favoured by all finance and accounting professionals regardless of their country of doing business.

TITLE
5. NET PRESENT VALUE
ABSTRACT
The difference between an investment's market value and its cost over a period of time is called the net present value (NPV). It shows the present value of the cash flows (discounted cash flows) at the required rate of return compared to the initial investment. It is a widely used method for analysing the profitability of an investment. Generally, an investment with a positive NPV indicates that the projected earnings generated by the investments exceed the anticipated costs. This is one of the most powerful investment criteria based on the time value of money principle.
GENERAL DESCRIPTION OF THE SPECIFIC ACTION
<p>Money in present is more valuable than money in future because of inflation, interest rates and opportunity costs, while money in present can be invested and grown. Net present value is a measure of how much value is created or added today by undertaking an investment. It is calculated when investment cost is deducted from present value of future cash flows. Net present value estimates depend on projected future cash flows. If there are errors in those projections, then our estimated NPVs can be misleading. We call this possibility forecasting risk.</p> <p>Steps in performing NPV valuation:</p> <ol style="list-style-type: none"> 1. Calculate the free cash flows for all periods under the investment horizon 2. Discount by the WACC 3. Add all the free cash flows for all periods under the investment horizon 4. Subtract the initial investment of the project <p>The NPV investment decision criterion is as follows:</p> <ul style="list-style-type: none"> • If $NPV > 0$, project is profitable, you should accept the investment proposal • If $NPV < 0$, project is unprofitable, you should reject the investment proposal <p>If you are a startup looking for a loan or seed financing, the NPV of the proposed investment will most likely be the first criterion by which your business idea will be judged</p>
Action Type
Actions that have prerequisites (other actions need to be implemented first), but require no investment.
Connected Actions
Action 4 – Discounted Cash Flow
Time required to implement a solution and when possible associated cost

Once you have acquired the necessary knowledge from the connected actions, you will need at least one day to practice calculating Net Present Value and understand its importance, dynamics and context.

Positive and Negative Part of the Solution

Positive:

- gives importance to time value of money, emphasizing earlier cash flows
- considers all the cash flows (before cash flow and after cash flow) involved through the life of the project
- profitability and risk of the project are given high priority
- has a decision-making mechanism – rejects projects with negative NPV

Negative:

- complicated and time consuming method
- difficult to calculate appropriate discount rate
- sensitive to the initial investment cost
- difficult to apply when comparing projects with different life spans

Estimated Exploitation

Once acquired, this technique will become indispensable for you any time you will need to make a rational decision and corroborate it with hard data.

ICT Competence

Intermediate.

English Language Skills

Basic, as this method mainly relies on math.

Webshop Level

N/A

Informative Text (Sources)

A Refresher on Net Present Value
 No one calculates NPV by hand. There is an NPV function in Excel that makes it easy once you've entered your stream of costs and benefits

<https://hbr.org/2014/11/a-refresher-on-net-present-value>

Additional Resources

1. Net Present Value
<https://www.investopedia.com/terms/n/npv.asp>
2. Net Present Value NPV

<http://www.investinganswers.com/financial-dictionary/technical-analysis/net-present-value-npv-2995>

3. Net Present Value

<https://courses.lumenlearning.com/boundless-finance/chapter/net-present-value/>

4. Net Present Value NPV

<https://www.preplounge.com/en/bootcamp.php/business-concept-library/common-terms-of-business/net-present-value-npv>

Cross Border remark

Similar to Discounted Cash Flows and the Internal Rate of Return, this is a standard technique that is used universally by all finance and accounting professionals across borders.

TITLE
6. INTERNAL RATE OF RETURN
ABSTRACT
<p>Internal rate of return (IRR) is the discount rate at which the net present value (NPV) of all the cash flows from a project or investment equals zero. When the internal rate of return of a project surpasses the required rate of return, the project is desirable. Generally speaking, the internal rate of return is the rate of growth a project is expected to generate without the interference of any external factors, such as the cost of capital, or inflation.</p> <p>IRR is closely related to NPV but is often preferred as an investment criterion by financial practitioners.</p>
GENERAL DESCRIPTION OF THE SPECIFIC ACTION
<p>Internal rate of return is a method commonly used to compare and decide between capital projects. The IRR method shows the return on the original money invested. Alternative and closely related to Net present value, it often leads to identical decisions. It is used to find a single rate of return that sum up the benefits of a project. Provides a benchmark figure for every project that can be assessed in reference to a company's capital structure. When project cash flows are not conventional, there may be no IRR or there may be more than one. More seriously, the IRR cannot be used to rank mutually exclusive projects. In some cases the IRR may have a practical advantage over the NPV. We can't estimate the NPV unless we know the appropriate discount rate, but we can still estimate the IRR. The internal rate of return helps manager to determine which potential projects add value and are worth undertaking.</p> <p>Steps in calculating IRR:</p> <ol style="list-style-type: none">1. Set the NPV formula equal to zero2. Calculate the rate of return3. Compare the IRR to required rate of return <p>Since the calculation can be tricky if done by hand, it is recommended that a financial calculator or Excel be used.</p> <p>The IRR investment decision criterion is as follows:</p> <ul style="list-style-type: none">• If $IRR > \text{required rate of return}$, project is profitable, you should accept the investment proposal• If $IRR < \text{required rate of return}$, project is unprofitable, you should reject the investment proposal <p>It is often proposed that modified internal rate of return (MIRR) is used because of problems with IRR. It is used to rank investments or projects of uneven size.</p>
Action Type

Actions that have prerequisites (other actions need to be implemented first), but require no investment.
Connected Actions
Action 4 - Discounted Cash Flow Action 5 - Net Present Value
Time required to implement a solution and when possible associated cost
Once you have acquired the necessary knowledge from the connected actions, you will need at least one day to practice calculating Net Present Value and understand its importance, dynamics and context.
Positive and Negative Part of the Solution
<p>Positive:</p> <ul style="list-style-type: none"> - Takes into account time value of money - Simple to use <p>Negative:</p> <ul style="list-style-type: none"> - Difficult to calculate - Not reliable when comparing mutually exclusive projects
Estimated Exploitation
Once acquired, this technique will become indispensable for you any time you will need to make a rational decision and corroborate it with hard data.
ICT Competence
Intermediate.
English Language Skills
Basic, as this method mainly relies on math.
Webshop Level
N/A
Informative Text (Sources)
Internal Rate of Return IRR and Modified IRR Explained: Definition, Meaning, and Example Calculations https://web.archive.org/web/20161115012434/https://www.business-case-analysis.com/internal-rate-of-return.html
Additional Resources
1. Internal Rate of Return

<https://accountingexplained.com/managerial/capital-budgeting/irr>

2. Internal Rate of Return Method

<https://www.accountingformanagement.org/internal-rate-of-return-method/>

3. IRR

<https://www.investopedia.com/terms/i/irr.asp>

1. Internal Rate of Return

<https://www.business-case-analysis.com/internal-rate-of-return.html>

Cross Border remark

Similar to Discounted Cash Flows and the Net Present Value, this is a standard technique that is used universally by all finance and accounting professionals across borders.

TITLE
7. BREAK-EVEN ANALYSIS
ABSTRACT
Break-even analysis is a popular and commonly used tool for analysing the relationship between sales volume and profitability. Break-even analysis requires the calculation and examination of the margin of safety for a business based on the revenue collected and associated costs. This is one of the most useful tools for predicting whether your startup will be profitable.
GENERAL DESCRIPTION OF THE SPECIFIC ACTON
<p>Break-even analysis is used to determine the point at which revenue received equals the costs associated with receiving the revenue. It is a supply-side analysis, only analysing the cost of the sales and not how demand might be affected on different pricing. Break-even analysis in its various forms is a particularly common type of scenario analysis that is useful for identifying critical levels of sales. To perform break-even analysis, it is important to know total costs and to have pricing strategy. If the product or service are brand new it might be challenging to predict the demand, which is the third factor in break-even analysis.</p> <p>Steps to do break-even analysis:</p> <ul style="list-style-type: none"> • Determine fixed costs – costs that don't depend on volume of production • Determine variable costs – costs that rise and decrease depending on volume of production • Determine selling price of your product – at least even to production costs • Calculate unit contribution margin – deducting variable costs from sales price • Calculate break-even point – volume of sales needed to cover all costs • Calculate profit and losses <p>Where:</p> <ul style="list-style-type: none"> • Fixed costs are costs that do not change with varying output (i.e. salary, rent, building machinery). • Sales price per unit is the selling price (unit selling price) per unit. • It is also helpful to note that sales price per unit minus variable cost per unit is the contribution margin per unit. <p>Therefore, the concept of break even point is as follows:</p> <ul style="list-style-type: none"> • Profit when Revenue > Total Variable cost + Total Fixed cost • Break-even point when Revenue = Total Variable cost + Total Fixed cost • Loss when Revenue < Total Variable cost + Total Fixed cost <p>Break even analysis is often a component of sensitivity analysis and scenario analysis performed by financial practitioners. Unlike NPV and IRR which are decision-making tools, Break-even analysis is primarily a planning aid.</p>
Action Type

Actions that have prerequisites (other actions need to be implemented first), but require no investment.
Connected Actions
Action 1 – Starting up with Accounting Action 6 - Expenses
Time required to implement a solution and when possible associated cost
Once you have acquired the necessary knowledge from the connected actions, you will need at least one day to practice calculating Net Present Value and understand its importance, dynamics and context.
Positive and Negative Part of the Solution
<p>Positive:</p> <ul style="list-style-type: none"> • Makes you think about the time horizon until your startup reaches profitability • Helps you understand the viability of your business proposition • Illustrates importance of keeping fixed costs down • Helps you understand the level of risk associated with a startup <p>Negative:</p> <ul style="list-style-type: none"> • Unrealistic assumptions • Sales are unlikely to be the same as output as there may be some buildup of stocks • If you sell more than one product, it will become harder to calculate
Estimated Exploitation
This technique will come in especially handy when you have to decide what the correct price of your product/service should be when putting it on the market.
ICT Competence
Intermediate.
English Language Skills
Intermediate.
Webshop Level
N/A
Informative Text (Sources)
Using a Break-even Analysis to Inform Pricing Decisions https://redfworkshop.org/learn/break-even-analysis/

Additional Resources

1. How to do a break-even analysis?

<https://www.thebalancesmb.com/how-to-do-a-break-even-analysis-398032>

2. How to perform a break-even analysis?

<https://www.inc.com/guides/2010/12/how-to-perform-a-break-even-analysis.html>

3. How to predict if your next venture will be profitable?

<https://www.shopify.com/blog/64297285-how-to-predict-if-your-next-venture-will-be-profitable>

Cross Border remark

Break-even analysis may be especially important if you are planning on serving international customers since prices will most likely differ across borders.