## FINANCIAL ANALYSIS: SECURITY OF INCOME

The break-even point of a business or a potential business is very important. It indicates exactly how much turnover would be required just to be break even – the point where the business would neither make a profit, nor suffer a loss. It would be able to meet its liabilities and, as such, keep remaining a going concern. The break-even point is a good indicator of risk, more specifically, risk in terms of the security of income.

Briefly consider a gift shop situated in a shopping mall, assuming that the rent alone is significant. Overheads would be high. Typically, the mark-up of a gift shop is very high, and its sales volume (very) limited. The break-even point would show exactly how much turnover is required to just break even. A skilled person would be able to tell whether the break-even turnover is achievable.

On a technical point we will, for purposes of this discussion, focus on entities which purchase or manufacture goods with the aim of selling it at a profit. Typically, you would have a mark-up on your cost price. The cost price would be the price at which you purchase or manufacture. The difference between the capitalised purchase / manufacturing cost and the selling price, would comprise gross profit. Expenses are paid out of gross profit to determine net profit.

The (critical) break-even turnover is the point where gross profit equals expenses. There can be only one break-even point. If you make a profit, or suffer a loss, you don't break even.

To determine a break-even point within a trading environment, you would have to **determine the turnover which would generate a gross profit equal to expenses**.

You need two values to calculate the break-even point: The value of total expenses, and a mark-up based on sales. **The mark-up needs to be expressed as a percentage of sales since you need to determine turnover.**

In a question you have nothing to worry about if the mark-up is given based on sales. You may simply continue doing the calculation. Should you, however, be given a mark-up based on cost of sales, it is essential to convert it to one based on sales since you express the break-even point in terms of sales (turnover). The manner in which to do this conversion is as follows:

Say, gross profit is defined as 50% on cost price. In order to say that gross profit amounts to 50% on cost of sales, the cost price will have to represent 100%, otherwise the 50% wouldn't be 50% of that value. Cost price plus gross profit would give you sales. 100%, being the cost price, plus 50% added, will result in sales being 150%. The gross profit as a percentage of sales would be 50% out of 150%, namely 33 1/3%. This means that a gross profit % of 50% on cost of sales will be equal to a gross profit of 33 1/3% based on sales.

If an entity earns investment income, such income will be "utilized" to reduce expenses. The turnover which would render gross profit equal to the remainder of expenses then needs to be determined. Note that if you don't decrease expenses by the amount of investment income, you will end up making a profit to the value of the investment income. The moment you make a profit, it is not a break-even point anymore.

**IN THE CALCULATION OF BREAK-EVEN TURNOVER ON PAGE 35 OF THE STUDY GUIDE, INVESTMENT INCOME HAS ERRONEOUSLY NOT BEEN DEDUCTED.**