Profit Breakeven is different than Cash Breakeven

In his article, I will discuss the difference between Breakeven Cash and Breaken Profit.

Steve, (an alias) an up and coming entrepreneur whose business is making great strides, shared his plans for 2018 with me.

Up until 2017, Steve generated 98% of his sales online.

An integral part of his growth strategy for 2017 was *expanding distribution* on his line of products to include brick and mortar wholesale accounts.

The strategy he implemented increased sales and brand awareness, and on the surface seemed to strengthen the financial viability of the business. One significant financial change Steve accounted for in planning the expansion was the change in his gross profit margin.

Sales to wholesale accounts involved lower price points than sales direct to consumers. This resulted in a reduced overall profit margin.

Steve did plan for this and forecasted the increased sales from the wholesale distribution channel would make up for the lower wholesale pricing and reduced profit margin.

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Exceeded Breakeven But…

Steve was pleased with the 2017 results. Sales increased to $790,000 and the business exceeded the breakeven point ($775,0000) and produced a small profit. His 2017 profit/loss projections indicated that this level of sales would allow the business to operate comfortably.

However, Steve was a bit perplexed by the fact that even though the business exceeded projected breakeven sales, available cash remained a challenge. He wondered how his projections could better prepare him for what to expect in 2018. After all, he wants to continue to grow but also knows that he needs to understand the business's cash needs.

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The Difference…

Selling to wholesale accounts involved an adjustment to the revenue model in Steve's business that he had not fully accounted for in his projections.

His online sales generate revenue at the time of the sell. In order to gain wholesale distribution, Steve has to offer wholesale accounts 30 day payment terms, which now means he has accounts receivable (money owed to the business but paid later) as a part of his revenue model.

On average he's carrying $35,000 per month. Even though he anticipated the change in his model, his breakeven projection did not speak to the total implications on the business's cash requirements.

Here's What Happened

Profit breakeven is different than **cash breakeven**.

Breakeven is where sales equal cost of goods or services plus operating expenses. To calculate breakeven the formula is operating expenses divided by gross profit margin. Let's look at Steve's breakeven calculation.

Sales $775,000 – $310,000 Cost of Goods = $465,000 Gross Profit
Gross Profit $465,000/$775,000 Sales = 60% Gross Profit Margin (GPM)
Operating Exp. $465,000 ÷ 60% GPM = $775,000 Profit Breakeven Sales

The profit breakeven includes all sales the business has made including those that have not been collected.

However, cash breakeven only accounts for actual revenue that is collected. Steve's business has accounts receivables on average of $35,000. When the accounts receivables is included in the cash breakeven calculation, here's what happens.

Profit Breakeven $775,000 – $35,000 Accounts Receivable = $740,000 Cash Collected
Cash Collected $740,000 – $310,000 Cost of Goods = $430,000 Gross Cash Margin (GCM)
GCM 430,000 ÷ $740,000 Cash Collected = 58% Cash Margin
Operating Expenses $465,000 ÷ 58% Cash Margin = $801,724 Cash Breakeven Sales

Steve needs sales of $801,724 to have enough cash to cover all expenses in his business.

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Of course he has other options for meeting his cash needs (i.e. loans, investors, etc.) but, absent of these options, he would have to achieve the cash breakeven sales level to meet his cash requirements.

The Takeaway…

Finances (cash, profits, etc.) are the most important issues for your business. If the money does not work, the business does not work. You must understand the various financial concerns involved and view those concerns from different perspectives.

For 2018, identify three areas of your business’s finances that you want to understand better and outline your strategy to do so.

Share your ideas with me and our audience of readers. I’ll pick 3 of the responses and provide personalized feedback!

Have a great 2018.

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