

**Regional Micro-Enterprise Credential – Key Financial Concepts Student Handout**

(Updated: June 12, 2017)

### Types of Ownership

Sole Proprietorship (or Partnership)	An individual (or group of individuals) owns the company. Owners are taxed on the profits of the company. Owners are personally liable for any debts or judgments against the company.
Corporation	A corporation is a person in the eyes of the law. The corporation is taxed for profits and is liable for any debts or judgments. Corporations are owned by shareholders (individuals or other corporations).
Limited Liability Corporation (LLC)	A special type of corporation where individual owners (or “members”) are taxed on the profits of the company, but the corporation (not the member-owners) is liable for debts or judgments against the company.

**For the purposes of the Micro-Enterprise Credential, we’ll assume all start-ups are LLCs.**

### Creating a “Pro Forma”

**A “pro forma” is a projection of your company’s financial performance.**

Business leaders brainstorm how well their company will do over the next year (or “quarter”) by considering two critical components of financial performance:

Revenue Projections	Cost Projections
<ul style="list-style-type: none"> <li>● What goods and services your enterprise will offer</li> <li>● What prices you will set</li> <li>● How many “units” you will sell</li> <li>● <b>“Total revenue” = units x price</b></li> </ul>	<ul style="list-style-type: none"> <li>● What “fixed costs” or overhead your enterprise will require</li> <li>● What “variable costs” are part of every unit you sell</li> <li>● <b>“Total costs” = [fixed costs] + [variable costs x units]</b></li> </ul>

**A business is profitable when its revenues are greater than its costs.**

See next page for the definition of those terms in quotation marks

### Definition of Key Terms: Creating a “Pro Forma”

Pro Forma	A Latin phrase (“for the sake of form”) that in business means a projection of future financial performance. A pro forma usually takes the form of a projection of future revenues and costs.
Quarter	Most projections are for a year (or “annual” projections). A “quarter” means three months. New and seasonable businesses are most likely to track quarterly projections to make sure they’re on track for success.
Units	Units refer to the “things” your company sells. Retail stores sell many different types of units. Service businesses can sell different services (example: men’s haircuts, women’s hair styling, manicures, etc.)
Fixed Costs	Costs that do not vary based on the units sold by your enterprise. Fixed costs are often incurred as you start your enterprise, before you know how well your enterprise will perform. Example: when you sign your lease, your store rent is now a fixed cost that will not vary based on how many units you sell.
Variable Costs Cost of Goods Sold	Costs that vary based on the units sold by your enterprise. “Cost of Goods Sold” are the costs that make up one unit of what you sell. These can be labor costs as well as material costs. Example: when you sell a hat, the variable costs include: a) the hat’s material; and b) the labor cost required to make the hat.
Total Revenue	Units times price. If your enterprise sells more than one type of unit, then your Total Revenue equals the sum of revenues created by selling each type of unit.
Total Costs	Fixed costs plus variable costs. If your enterprise sells more than one type of unit, your Total Costs equal the sum of your fixed costs and the sum of variable costs (or cost of goods sold) for each type of unit.
<b>Extra Credit Concepts</b>	
Cash Flow	Total Revenues minus Total Cost <i>minus one-time expenditures (called “capital expenditures”)</i> on equipment you will use for many years.
Semi-Variable Costs	Costs that vary <i>somewhat</i> based on the number of units you sell. Example: if your enterprise buys an iPhone you won’t have to pay again for apps you already own.

Take the Concepts Quiz on the next page to prove your mastery of key pro forma concepts.

## Concepts Quiz

You open a new gourmet ice cream shop in a temperate weather community because you believe you'll be able to attract customers throughout the year. The summer tourist season will be by far the busiest time of year, but your shop will consistently attract local residents throughout the year.

You found a great location. The owner of the shop is retiring so she will rent you the shop that already has all the freezers and equipment you'll need.

The appeal of your shop will be the unbelievable quality of your ice cream. You'll serve the ice cream per scoop, in small and large sundaes, and in milkshakes.

### Quiz Questions

When you create your pro forma for this business, should you assume the same revenues for each quarter?  
Why or why not?

List two or more variable costs for this business.

List at least one fixed cost for this business.

Check the correct answer:	Fixed Cost	Variable Cost	Semi-Variable Cost
Ice cream cones			
Business insurance			
Hourly labor			
Electricity Costs			

Extra Credit: What business decision would increase the amount of this ice cream store's electricity bills?

Extra Credit: If you decide to buy a new milkshake mixer to produce more milkshakes, what needs to happen for your cash flow to go up, not down?

## Determining “Contribution Margin” (your profit per unit)

Business leaders calculate the profit per unit to make good business decisions.

For your ice cream store, the costs for your different menu items are:

Menu Item	Ingredients	Labor Cost	Cones or Cups	Total Cost of Goods Sold
One scoop	\$1.25	45¢	10¢	\$1.80
Two scoops	\$2.50	90¢	10¢	\$3.50
Small sundae	\$3.00	\$1.00	10¢	\$4.10
Large sundae	\$4.50	\$1.20	10¢	\$5.80
Milkshake	\$2.75	\$1.50	15¢	\$4.40

Now that you know your costs per unit, you can set your price. ***Your contribution margin (or profit per unit) will be: Unit Price – Unit Cost of Goods Sold***

What does your price depend on? Many factors:

- What your items costs (because you always want a price above your cost!).
- The prices of competitive ice cream stores that are nearby.
- What you believe is the value and quality of your ice cream.

In the chart below enter the prices you believe are “right” for each item. Calculate your contribution margin. Be prepared to defend why you’ve set the right prices.

Menu Item	Price	Cost of Goods Sold	Contribution Margin
One scoop		\$1.80	
Two scoops		\$3.50	
Small sundae		\$4.10	
Large sundae		\$5.80	
Milkshake		\$4.40	

Discussion: Why are these

the “right” prices for your store?

## Fixed Costs (including Start-Up Costs)

What would be some of the fixed costs as you operate this ice cream store?

- Your monthly rent. No matter how many or how few customers you have you will owe your landlord the same amount of rent each month.
- Business insurance. Businesses typically need several different types of insurance (example: liability insurance to protect them against accidents on their premises). The cost of this insurance is the same regardless of how many customers the store will have.
- Overhead salaries. If your store hires a bookkeeper to help keep your records, you will need to pay this bookkeeper his/her salary no matter how many customers come to your store.

To make an accurate pro forma projection of future financial results, an enterprise needs to make sure it understands the fixed costs it will incur.

***Note: one item not mentioned so far is how much you’re going to pay yourself as the owner-operator of a business.***

In the experience of most entrepreneurs, how much the owner gets paid only gets determined *after* the business succeeds. That’s why many new businesses create a pro forma that shows: “Profits before taxes and owner compensation.”

The hope of every business owner: that his/her “profit before taxes and owner compensation” is far greater than he/she would earn working for anyone else.

### Extra Credit Concept – Semi-Variable Costs

Utility costs (electricity, water) vary *somewhat* with how many customers you serve. Utility bills come with a fixed component that your business will pay no matter how many customers you serve.

But – for example – if you stay open late at night or if your milkshake mixer uses a lot of electricity, then your utility bills would go up based on serving these additional customers.

When a business makes a projection of how much its utility costs will be – or other “semi-variable” costs like facility maintenance (you need to clean the store each evening, but stores that serve more customers require more maintenance) – your projections should consider both the truly fixed component of these costs as well as the operating decisions you’ll make that might increase these costs beyond their fixed level.

## Creating Your Own Pro Forma Financial Projection

Let's try something very challenging: *let's complete an annual pro forma financial projection for this ice cream store:*

- with quarterly projections that reflect more revenue during your busy summer season;
- using the financial information established below for prices, fixed costs, both variable costs and semi-variable costs, and units sold.

This will be a pretty sophisticated assignment . . . so don't get discouraged. *Act like an entrepreneur and show some grit!*

Menu Item	Summer Quarter Units Sold	Units Sold: All other Months			
One scoop	3,000 per month	1,000 per month			
Two scoops	3,000 per month	1,000 per month			
Small sundae	1,200 per month	500 per month			
Large sundae	600 per month	200 per month			
Milkshake	800 per month	800 per month			
Fixed Costs:	Monthly Rent	Annual Insurance Costs (payable in quarterly installments)		Annual Salary for the Part-Time Bookkeeper	
	\$4,000	\$2,400		\$24,000	
Menu Item	Price	Cost of Goods Sold	Contribution Margin		
One scoop	\$4.00	\$1.80	\$2.20 (55% of price)		
Two scoops	\$8.00	\$3.50	\$4.50 (56% of price)		
Small sundae	\$9.00	\$4.10	\$4.90 (54% of price)		
Large sundae	\$12.00	\$5.80	\$6.20 (52% of price)		
Milkshake	\$9.00	\$4.40	\$4.60 (51% of price)		
Semi-Variable Costs:	Utilities – Fixed Charges	Utilities – Extended Summer Hours	Utilities – All other months	Monthly Maintenance Charges:	
	\$500 / month	\$1,000 / month	\$100 / month	Summer: \$900	Other: \$300
Advertising	Pre-Summer Quarter (Mar – May)		Summer (Jun – Aug)	All Other Months	

Costs:	\$2,000 / month	\$500 / month	\$1,000 / month
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If you want to attempt this exercise your teacher can provide you with a spreadsheet that will help you.

### Questions on the Pro Forma

Does this pro forma indicate that your ice cream shop might be a profitable venture? Would you find this opportunity attractive?	
Which is the most profitable menu item? Can you determine why?	
Milkshakes are less profitable on a per unit basis than any other item. But what's attractive about milkshakes that might keep them on the menu?	
Why might it make sense for this business to advertise more during the slow seasons, but cut advertising during the summer?	
How many more milkshakes would this store need to sell in order to pay for a new milkshake mixer that costs \$7,360?	(This is also called a "breakeven analysis")
What are some of the major risks in pursuing this new venture?	
How often do you think the owner of this store would take vacation during the summer? Why or why not?	
Do you think this is a good business opportunity for an entrepreneur?	



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***Congratulations! You've finished the Key Financial Concepts module of the Jump Start Micro-Enterprise Credential materials.***