How to Conduct a Financial Impact Analysis

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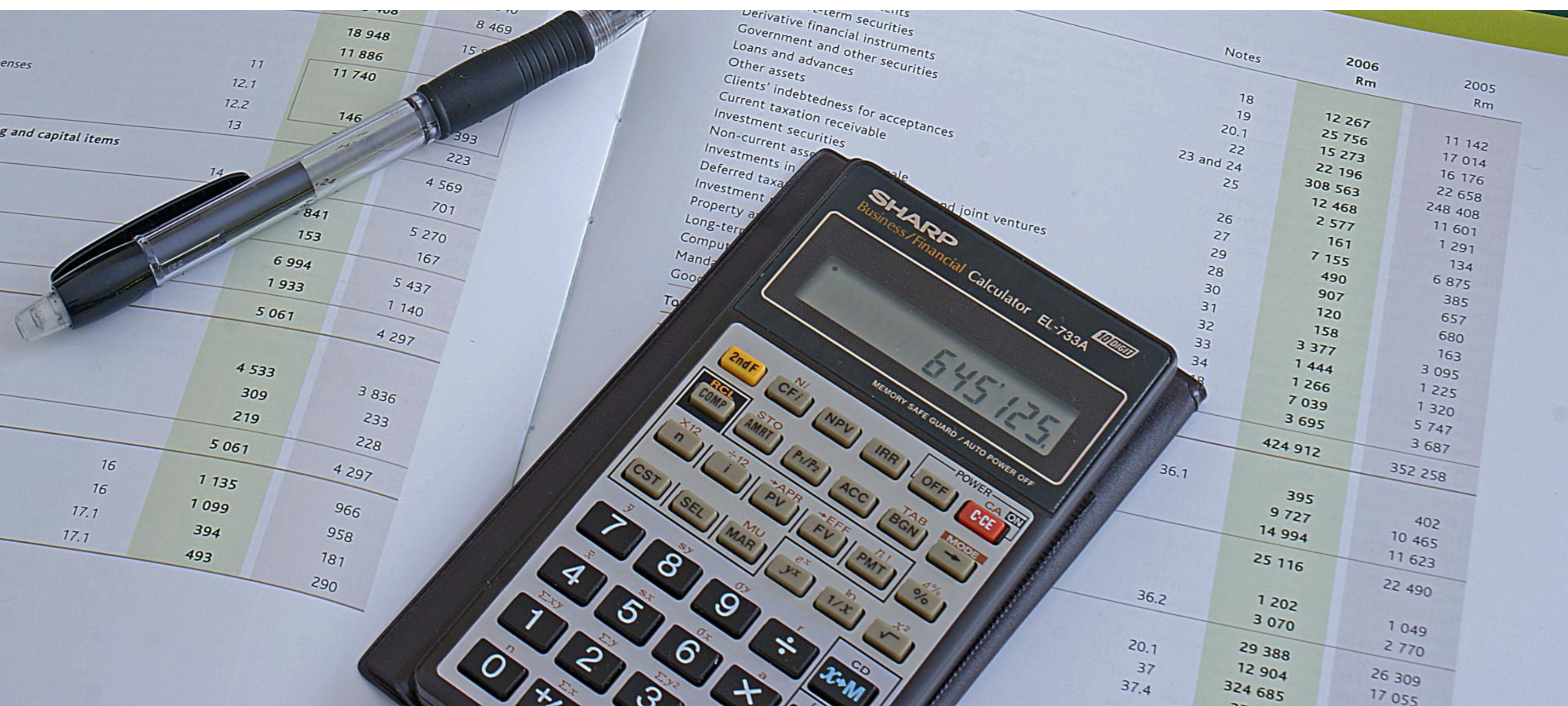
A ***financial impact analysis*** is a methodology by which you can convert a differential in a margin or a ratio to a monetary value.

It’s useful when talking to clients about perceived concerns that you might have in the financial performance or the financial structure of the business.

So the process begins with a normal ratio analysis during the course of which you notice a deteriorating trend in a ratio or a margin (percentage) and you want to discuss this variation with the client's owners, managers or directors.



Depending on the level of financial sophistication that the owners /managers / directors have, it's often easier to talk in money terms than in ratios or percentages.

Also, doing that has the advantage of showing the actual scale of the variation as an amount of money.

Let’s use an example to illustrate;

Say that you analysed the financial statements of a company and found that the gross profit margin had reduced from 56% to 50% on a turnover of 10 million.

You decide to bring this to the attention of the company’s directors but when you do, the managing director says;

“it’s only 6%.....
…….nothing to worry about”

By conducting a financial impact analysis you can convert that 6% differential into a real monetary value to help make your point.

Here's what you do……

You calculate the gross profit that the company ***actually*** made;

10m (revenue) x 50% (gross profit margin)

= 5m in gross profit

Then you calculate the gross profit that the company ***could have*** made if the gross profit margin had remained at 56% (that's called the target gross profit margin);

10m (revenue) x 56% (*target* gross profit margin)

= 5,6m gross profit

So the difference between the two gross profit figures of 600,000 is the *financial impact* of the company achieving a 50% gross profit margin instead of the previous 56% on the same level of revenue.

When the managing director realises that the drop in the gross profit margin actually caused them a drop in profit of 600,000, she might feel it ***is*** something to worry about!

You can use any ratio or margin (percentage) for the target.

It could be a past ratio or margin from a time when the company performed well or it could be an industry benchmark or even a ratio or margin required in terms of a covenant in a facility letter.