Financial accounting essay sample

ASSIGN BUSTER

In this assignment, we will be discussing, analysing and evaluating a company's management and marketing strategies through different marketing proposals. The concept of Cost – Profit – Volume (CVP) analysis, break-even analysis and knowledge of fixed and variable costs will be looked into particularly as it will aid in achieving the above mentioned objectives.

CVP Analysis can be defined as a management accounting tool used to determine the point of maximum profit in relation to efforts made in creating sales volume and costs incurred in making those efforts. It is very essential for developing business goals and forming marketing strategies. CVP analysis can be used in the form of an equation or a graph.

Break – Even Analysis is another commonly used technique in management accounting which is based on comparing and categorising production costs (that is either as variable costs or fixed costs). Total costs (variable plus fixed) are compared with total sales revenue to establish the level of sales volume or value at which the business is neither making a profit nor a loss (the ' Break-Even Point'). The determination of the break-even point can be used to analyse the potential profitability on expenditure in a sales-based business.

It is very important for management accountants to use these techniques in order to control, review and make correct decisions, in allocating flexible budgets in order to forecast accurate profits and making the right pricing decisions on sale of products.

The company in discussion in this assignment is Beyond Fuel Ltd. It manufactures and sells a single product, EcoPlus, which is a fuel saving devise for motor vehicles.

Differences between an economist's break-even chart and an accountant's break-even chart.

A break-even chart is a graphical representation of the relationship between total sales output and total generated revenue. Its sole use is to determine the break-even point whose analysis helps consider if the venture is running at a profit or a loss.

Due to the assumptions employed by accountants and not normally by economists when seeking to explain the behaviour of business, their representation of break-even charts is different.

In a perfect market, the economist's portrayal of the total revenue line is linear, and so will be in agreement with the accountant's view. However, considering imperfect markets, the total revenue line on an economists' break-even chart is curvilinear. This is because, in order to increase sales value, businesses tend to decrease selling price per unit of goods sold. In so doing, the total revenue of the business does not increase in direct proportion to output, hence a curvilinear revenue line.

[Scarlett, B. (2007) Management Accounting: Performance evaluation, 4th ed. Oxford: Butterworth – Heinemann, pp. 157].

Also, the total cost line portrayed on an economists' break-even chart is curvilinear. Total costs rise quite steeply at the beginning largely due to the

fact that average variable cost per unit are relatively high at low levels of output. However, as output begin to rise; average variable cost per unit decrease. This is caused by the factors of economies of scale. This decline in average cost per unit results in the levelling out of the total cost line. Beyond a certain output level, the average variable costs begin to rise once again causing the total cost line to rise more steeply. This situation arises due to inefficiency in operating capacity.

[Atrill, P and McLaney, E. (1994) Management Accounting: An Active Learning Approach. Chichester: Wiley – Blackwell, pp – 161]

An illustrative diagram of two different perspectives of the break-even chart is shown below.

Looking at the representation above, one can conclude that the economists' chart shows the theoretical relationship of costs at different volumes and the accountants' chart show the relation of the firms' costs at normal operating activity i. e. within the relevant range. Also the economists' chart shows two break-even points whereas the accountants' chart indicates only one. However, within the relevant range both representations are similar and the linearity rational.

Period of Time and Relevant Range in the context of Fixed Cost

Fixed costs can be defined as the costs that do not vary with the activity level or volume of sales of the business. This is generally true assuming normal operating activity is for a short term called the relevant range. Relevant range is the range of normal operating activity when fixed costs

behave in a linear fashion. Beyond this range fixed costs do not remain fixed as no observations can be made. It can also be said that fixed costs remain fixed only over a certain period of time. After this time, the costs may change either due to increase or decrease in costs.

For example, considering Beyond Fuel Ltd’s administration overheads, they are fixed for both halves of the year. Assuming that the administration overheads change for the following year, the period of time for the administration overheads to be fixed for Beyond Fuel Ltd was 1 year. However, these two assumptions are normally ignored when defining fixed costs as ‘ costs that remain unchanged when production levels change’.