

Assumptions on cost-volume-profit analysis

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Cost-volume-profit (CVP) analysis is used to expand and update the information obtained from breakeven analysis. It is necessary to underline that the critical part of the analysis is defined as the point where total costs equal total revenues or, in other words, when fixed and variable costs equal total revenues. Actually, at this point the company is claimed not to experience losses and gains. This breakeven point is an initial examination and CVP analysis follows it.

Cost-volume-profit analysis shares similar important assumptions as breakeven analysis. These assumptions are:

- The behavior of revenues and costs is claimed to be linear throughout the relevant activity range. It means that the concept of volume discounts on either sales or purchased materials.
- The only factor affecting the costs is considered changes in activities.
- Costs are classified as variable and fixed and such classification is precise.
- No ending finished goods inventories are observed as all produced units are sold.

- The sales mix is constant when the company is selling more than one production line and sales mix is defined as the ratio of each production line to total sales. One more essential assumption is that in case a unit is produced in a particular year, it should be sold this year as unsold units are distorting the analysis. Unsold products are marked in books and defined as finished goods inventory. Further, such units are re-classified as assets and they are transferred to the next year.

However, the risk that these goods won't be salable the next year because of deterioration and obsolescence is very high. CVP can be also used to develop probability distributions in manufacturing firms and in restaurant industry.

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CVP analysis is rather simple and it is often used too explore the potential profit and pricing decisions. References Caldwell, Ch. W. , & Welch, J. K. (1989). Applications of Cost-Profit-Volume Analysis in the Governmental Environment. Government Accountants Journal, Summer, 3-8. .