Evaluate the reliability of break-even

As I have already summarised the breakeven point is the point at which cost or expenses and revenue are equal: there is no net loss or gain, and one has broken even. [Selling price-variable costs= contribution] [Fixed costs/contribution= breakeven point]So in your businesses scenario it is, the selling price £15 minus your variable costs £12 which equals £3. This then leaves you with your fixed costs which are 11, 500 divided by the contribution which £3 is leaving you with a total breakeven point of, 3833. 33.

First of all, production managers like Mr Jones and management accountants need to have a clear understanding of break-even analysis. This analysis is used as a general guideline for business decision making and is important for a number of reasons, including the ability to forecast the future cost and revenues and determine whether the business is making profit or loss, and also be able to develop a pricing strategy. The break-even analysis is based on marginal costing. The break-even analysis is based on forecasting and has a certain limitations which should be considered. It is not always possible to predict what will happen on the market.

The linear relationship is based on the presumption that costs remain constant. However this is not the case in practical market situations. The business may get some discount from its suppliers. Also the business can often reduce its selling price in order to increase its sales volume and this is an efficient strategy known as a non-linear relationship. The break-even analysis is internal and it is not used to consider the things like competition or market demand which means that the business should use other analysis to watch what is happening on the market and what strategies are used by competitors.

Limitations/assumptions of break even analysis: All costs are classified as either fixed or variable. If not impossible or impractical, dividing costs into the variable and fixed cost elements as an extremely difficult job. This is attributable to the inherent nature or characteristics of the cost per selling-product. Fixed costs remain constant within the relevant range.

Fixed costs remain unchanged at any level of activity within the relevant range, even at the zero level. The behaviour of total revenues and total costs will be linear over the relevant range, i. e. will appear as a straight line on the Break-even chart.

This is based on the idea that variable costs vary in direct proportion to volume; the fixed costs remain unchanged, hence drawn as a straight horizontal line on the graph within the relevant range; and that selling price is constant. In case of multiple product companies, the selling prices, costs and proportion of units (sales mix) sold will not change. This cannot always be correct. Sales mix ratio may be due to the change in the consuming habits of customers. Selling prices of the individual products may likewise change due to competition, popularity and saleability of the products, etc.

There is no significant change in the inventory levels during the period under review. Stated in another way, production volume is assumed to be almost (if not exactly) equal to the sales volume, which causes an immaterial (or none at all) difference between the beginning and ending inventories. Other assumptions which have already been discussed in the preceding numbers are again credited and highlighted here as follows: Unit selling price will remain constant. Unit variable cost will not change. (This may include prices of the factors of production like material costs, labour costs etc.)There will be no change in efficiency and productivity.

The design of the product will not change. (A change in the design of the product may bring about a change in production costs, selling price and production volume. Contribution and overheads behaviour: Overheads, also known as indirect costs, are " costs that are incurred by an organisation that cannot be distinctly attributed to a cost object" i. e.

something for which a cost is required. It is important for organisations to cover all costs that it creates; accounting for overheads has become more important in modern times as it takes up a larger percentage of the costs an organisation implicates. The main issue associated for accounting for overheads is that indirect costs are difficult to categorise and they cannot be easily traced to a specific cost. Overheads were traditionally, and still are accounted for using Marginal and Absorption Costing. However, the traditional system has its defects and more recently; Activity Based Costing was introduced for more accurate product and customer costing.

External factors Inflation: External factors such as changes in inflation, exchange rates and price elasticity of demand will affect the value of an asset or liability therefore contrasts with values in historical cost accounts. An increase in inflation rates will cause a loss in the real value of money therefore a balance sheet containing historical values will prove to be incorrect and hence an inaccurate measure of an entity's worth. Values presented on the balance sheet are seen as book values or the cost of the asset at the time of acquisition and therefore does not represent the current or market value. Its market value is the cost at which a company could sell their assets in current markets today.

As a result of this a distortion in the value of assets is created as the value of money changes. The time frame between the acquisition of an asset and the use of an asset to create revenue for an entity also creates a distortion particularly in the measurement of income. Therefore, a large difference can be seen in the acquisition cost and current cost of fixed assets such as stocks when costs are matched against revenue. So inflation will affect the costs of the business first. Fixed costs may be higher because wages and salaries may have to be increased so that they are not adversely affected by the inflation. Variable costs will also increase because suppliers are passing on their additional costs, making raw materials and components more expensive.

Inflation is an important factor that affects the values resulting from historical cost accounting; as general prices rises historical values will hold no resemblance to current values and hence an overstatement is made when measuring income. In relation to the balance sheet, an overstatement in income will result in an over optimistic profit level, this will also be reflected in the profit and loss accounts. Interest rates: The amount charged, expressed as a percentage of principal, by a lender to a borrower for the use of assets. Interest rates are typically noted on an annual basis, known as the annual percentage rate (APR). The assets borrowed could include, cash, consumer goods, large assets, such as a vehicle or building.

Interest is essentially a rental, or leasing charge to the borrower, for the asset’s use. In the case of a large asset, like a vehicle or building, the interest rate is sometimes known as the “ lease rate”. And a rise in interest rates will make it more expensive for a business to service its own debts, adding to the costs of the business. At the same time, the business’s total revenue may be driven down because demand will have been affected by the interest rate rise.