Features of cost-volume profit analysis

Business

The CVP analysis is important in analyzing the effect of different cost structures in a company. It is essential that organizations understand the cost structures of their business because of their effects on volume and profits. Another key feature of CVP analysis is that the cost structures greatly affect operating and investment decisions. CVP analysis also helps identify products or operations which should be discontinued if their contribution to profit is very minimal only. Managers are interested in the break-even analysis point because it is important to determine the volume of sales needed in order to be able to cover both the fixed costs and the variable costs. It is at this point that sales are equal to fixed costs and variable costs (Accounting for Management, n. d.). The break-even analysis illustrates the relationship between sales and production costs. Its analysis can be extended further and show how changes in prices of goods and fixed and variable costs will affect the profit levels (Gutierrez & Dalsted, 2012). For managers, the break-even point is the " lowest amount of business activity necessary to prevent losses" (Gutierrez & Dalsted, 2012). Managers use the break-even analysis for analyzing capital expenditures (MIRA Consulting, 2007). Break-even is one method of determining if it is advantageous for the firm to carry out a capital expenditure. Another reason why managers are interested in the break-even analysis is that it serves as a guide in deciding the pricing policies that the company will undertake. Prices can either be increased or lowered by considering the break-even point. In the same manner, labor costs are also established with the help of the break-even point. Since a portion of the labor costs may be divided into a fixed cost and a variable cost component, it is a factor considered in the amount of salary to be paid to the workers. Usually, the fixed labor costs are the salaries of

the administrative staff while the variable component of labor costs are the direct labor costs, which tend to increase as the volume of production increases. With break-even point analysis, managers will be forced to study and understand the cost structure of the company. The analysis will require managers to specifically identify which are fixed and variable costs. Break-even analysis helps a manager decide whether when an investment will generate a positive return (Gutierrez & Dalsted, 2012). Since the break-even point analysis will show the contribution of every unit sold above that point, it will give the manager an idea of how much a unit sold will add to the profit. Managers can, therefore, determine more or less if an investment will be profitable. “ Contribution margin is the total revenue minus total variable cost” (John Wiley & Sons, Inc., n. d.). Fixed costs are not included in the contribution margin. The exclusion of fixed costs in the contribution margin gives one a clearer picture of the contribution of a product to the profitability of a firm. Products are better compared if the fixed costs are not included. Fixed costs are costs which are not directly related to the level of production (Gutierrez & Dalsted, 2012). This means that even if a company increases the volume of production, the fixed costs remain unchanged. Examples of fixed costs are depreciation, interest costs, taxes, administrative salaries, insurance, rent, and general overhead expenses. The contribution margin per unit covers the fixed cost and gives the operating profit.