Summary

Break Even Analysis

Most entrepreneurs, rightly so, are focused towards the goal of achieving profitability. One important step before one achieves a profitable business, is the point when the business achieves Break-Even. This is the point, when on a running basis, the business can make enough revenues to cover all costs. In simple terms, this is a stage when the business is at no-profit-no-loss.

Elements of Cost and Break Even Point

Any business involves several expenses on an ongoing basis, each of which behaves differently. Based on this, costs can be categorised under the following three headings:

1. Variable Cost: These are costs that vary directly with production output. They increase with increases in the volume of production and vice versa, e.g. raw material cost.
2. Fixed Cost: These are costs that remain stable and do not change as the production level changes, e.g. Rent.
3. Semi-variable Cost: These are costs that have both fixed and variable component in it, e.g. electricity bill.

The point where total cost equals total revenue is called Break Even Point (BEP). Proper analysis of this stage is required to draw valuable findings. Every startup aspires to reach BEP at the earliest so that they can then reach the next stage of profitability faster. Revenues and costs can also be drawn out on a graph to understand and analyse the Break Even Point.

Change in Costs and Margin of Safety

Contribution represents that portion of sales which is not consumed by variable cost and thus contributes to the cover fixed cost. Contribution is calculated by deducting variable costs from sales.

The break-even of a business is a function of its revenues and its costs. Thus, a change in the costs of the business greatly impacts the time and manner in which the business achieves break-even. For example, when Fixed Cost goes up, you need to improve your Contribution Margin. Similarly, the Break Even Point can be achieved sooner by increasing the per unit selling price or reducing variable cost per unit.

Another related and important concept is Margin of Safety. The Revenue earned over and above the Break Even Point is called Margin of Safety. This is the cushion that generates profit for the entity. Though Break Even Point is a No Profit-No Loss situation, Margin of Safety (MOS) is desirable.

You should be able to:

At the end of this session, you should be able to:

1. Identify and understand the various cost elements for your business venture
2. Analyse the break-even point for your venture, even under changing circumstances