

Ganpat University – Institute of Computer Technology

Course on: Entrepreneurship Development (2HS309)

Theory of Production

{ Strategy from Raw Materials to Finished Goods }

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WHAT is?

Entrepreneurship is all about

CONVERTING CREATIVE IDEAS into **INNOVATION**

that solves **UNMET REAL NEEDS OF USER**

through **FEASIBLE TECHNOLOGY**

and **VIABLE BUSINESS MODEL.**



1. Idea



2. Product



3. Team



4. Execution

3 Pillars: Technology, People, Business Processes

Other factors

- Assess your financial assets
- Legal structure of a business - Company name, logo, LLP/PVT. LTD. Etc.
- Government registrations, Tax, Accounting, Record management
- IPR & Commercialization
- Branding & marketing strategy

Stages of Entrepreneurial Process

- Hypothesis Testing/Conducting Opportunity Analysis
- Developing & validating idea AND Creating a Value
- **Building product and customer base**
- **Developing Business Plan and Creating a venture**
- Acquiring and tie-up with funding sources
- Implementing the plan
- Scaling and growing the venture

Business Model



CREATE

Product/Service



DELIVER

Organization

Customer



CAPTURE

Revenue (\$)



Production Theory

In economics, production theory explains the various principles in which the business build, operate, take decisions like –

- How much of each commodity it sells
- How much it produces as outcome
- How much of raw material ie., fixed capital and labour it employs and How much it will use.

“The theory of production consists of how the producer, given the state of technology, combines various inputs to produce a definite amount of output in an economically efficient manner.”

Theory of production also seeks to explain the relationship between input and output.

Definition

Production is a process of **combining various inputs to produce an output for consumption**. It is the act of creating output in the form of a goods (commodity) or a service which contributes to the utility of individuals. (Source: Wikipedia)

Production defines as a process through which **the inputs are converted into outputs to be consumed**.

Commodity: a raw material or primary agricultural product that can be bought and sold, such as copper or coffee.

Production Analysis

Production analysis basically is concerned with the analysis in which the resources such as land, labor, and capital are employed to produce a firm's final product.

To produce these goods the basic inputs are classified into two divisions –

- **Variable Inputs:** Inputs that change or are variable in the short run or long run.
- **Fixed Inputs:** Inputs that remain constant in the short term are fixed inputs.

Meaning of Production

Raw cotton obtained directly at its place of origin i.e. the cotton fields is of **moderate significance**.

However, the same raw cotton, when transported to the vicinity of a textile mill assumes **high value**.

This is a classic example of **how transportation to a place of significance can add to the value of a material**.

Meaning of Production

Production is an activity of utter **importance for any economy**. In fact, a nation with a high level of productive activities spearheads the prosperity charts.

The countries that have a high level of production accompanied by the production of a wide variety of goods, are termed as the golden economies.

Hence, production is the process of working upon the resources of nature and pushing or creating their utilities in order to satisfy the wants of consumers.

Meaning of Production

- Production is not only concerned with the **tangible aspect**. Rather production also includes any service that can satisfy the wants of people. The **service of transportation** is a process of production too **which is intangible**.
- It is important to note that production cannot account for the creation of the seed, but it accounts for the transformation of the seed into a tree, the sale of the fruits grown on that tree and so on. In other words, production is not the creation of matter, which is also out of the realms of human powers.

Production Function

- Production function refers to the functional relationship between the quantity of good produced (output) and the factors of production (inputs) necessary to produce it.
- According to Watson, “The relation between a firm’s physical production (output) and the material factors of production (inputs) referred to as production function.”
- The inputs are the various factors of production- land, labour, capital and enterprise whereas the outputs are the goods and services.
- Further, it can also help us in determining the inputs we require to achieve a minimum level of production (outcome).
- Production function is defined for a given state of technology.

Assumptions of Production Function

The various assumptions of production function are:

- It is related to **a particular unit of time**.
- The **technical knowledge** during that **time period remains constant**.
- The producer uses the **best technique available**.

Production Function

According to Richard H. Lefthich, The Production function signifies a technical relationship between the physical inputs and physical outputs of the firm, per unit of time leaving prices aside.

$$Q = f(a, b, c, \dots, z)$$

Where a,b,c ...z are various inputs such as land, labor, capital etc. Q is the level of the output for a firm.

If labor (L) and capital (K) are only the input factors, the production function reduces to –

$$Q = f(L, K)$$

Production Function describes the technological relationship between inputs and outputs. It is a tool that analysis the qualitative input – output relationship and also represents the technology of a firm or the economy as a whole.

Cost Function

Cost function is defined as the relationship between the cost of the product and the output.

Following is the formula for the same –

$$C = F [Q]$$

Short Run Vs. Long Run - Costs

- The production function needs to be looked through two-time frames: **Short run and Long run.**
- **The short run** is a short interval of time, in which we can change only the variable factors of production.
- These variable factors are the ones which we can change over a small period of time, as the number of labour, raw material, fuel, power, etc.
- Symbolically, $Q = T(K, L)$. Further, we do this with the help of the law of variable proportions.

Following are the basic three types of short run cost –

Short run fixed cost

- Fixed cost is a cost which won't change with the changes in the output.
- For example, Building rent, Insurance charges, etc

Variable cost

- Variable cost is the cost which changes with the change in the output.
- For example, Cost of raw material, Wages, Electricity, Telephone charges, etc.

Short run total cost

- The total actual cost that is supposed to be incurred to produce a given output is short run total cost
- Total cost = Total Fixed Cost + Total Variable Cost

Short Run Vs. Long Run

- On the other hand, **the long run** is a relatively much longer period of time. Obviously, in the long run, we can change all the factors of production i.e. both fixed and variable factors.
- Hence, in the long run, we can change the factory size, techniques of production, machinery, to the number of labours, power, fuel and so on.
- Long-run cost is variable and a firm adjusts all its inputs to make sure that its cost of production is as low as possible.
- Thus the production function takes different forms according to the two-time frames. Evidently, we study production function with respect to two different time frames. The long-run production function is the subject matter of the law of returns to scale.

Law of Variable Proportions

The law of variable proportions has following three different phases –

- **Returns to a Factor**
- **Returns to a Scale**
- **Isoquants**

Returns to a Factor

Increasing Returns to a Factor

- Increasing returns to a factor refers to the situation in which total output tends to increase at an increasing rate when more of variable factor is mixed with the fixed factor of production. In such a case, marginal product of the variable factor must be increasing. Inversely, marginal price of production must be diminishing.

Constant Returns to a Factor

- Constant returns to a factor refers to the stage when increasing the application of the variable factor does not result in increasing the marginal product of the factor – rather, marginal product of the factor tends to stabilize. Accordingly, total output increases only at a constant rate.

Diminishing Returns to a Factor

- Diminishing returns to a factor refers to a situation in which the total output tends to increase at a diminishing rate when more of the variable factor is combined with the fixed factor of production. In such a situation, marginal product of the variable must be diminishing. Inversely the marginal cost of production must be increasing.

Returns to a Scale

If all inputs are changed simultaneously or proportionately, then the concept of returns to scale has to be used to understand the behavior of output. The behavior of output is studied when all the factors of production are changed in the same direction and proportion. Returns to scale are classified as follows –

Increasing returns to scale – If output increases more than proportionate to the increase in all inputs.

Constant returns to scale – If all inputs are increased by some proportion, output will also increase by the same proportion.

Decreasing returns to scale – If increase in output is less than proportionate to the increase in all inputs.

For example – If all factors of production are doubled and output increases by more than two times, then the situation is of increasing returns to scale. On the other hand, if output does not double even after a 100 per cent increase in input factors, we have diminishing returns to scale.

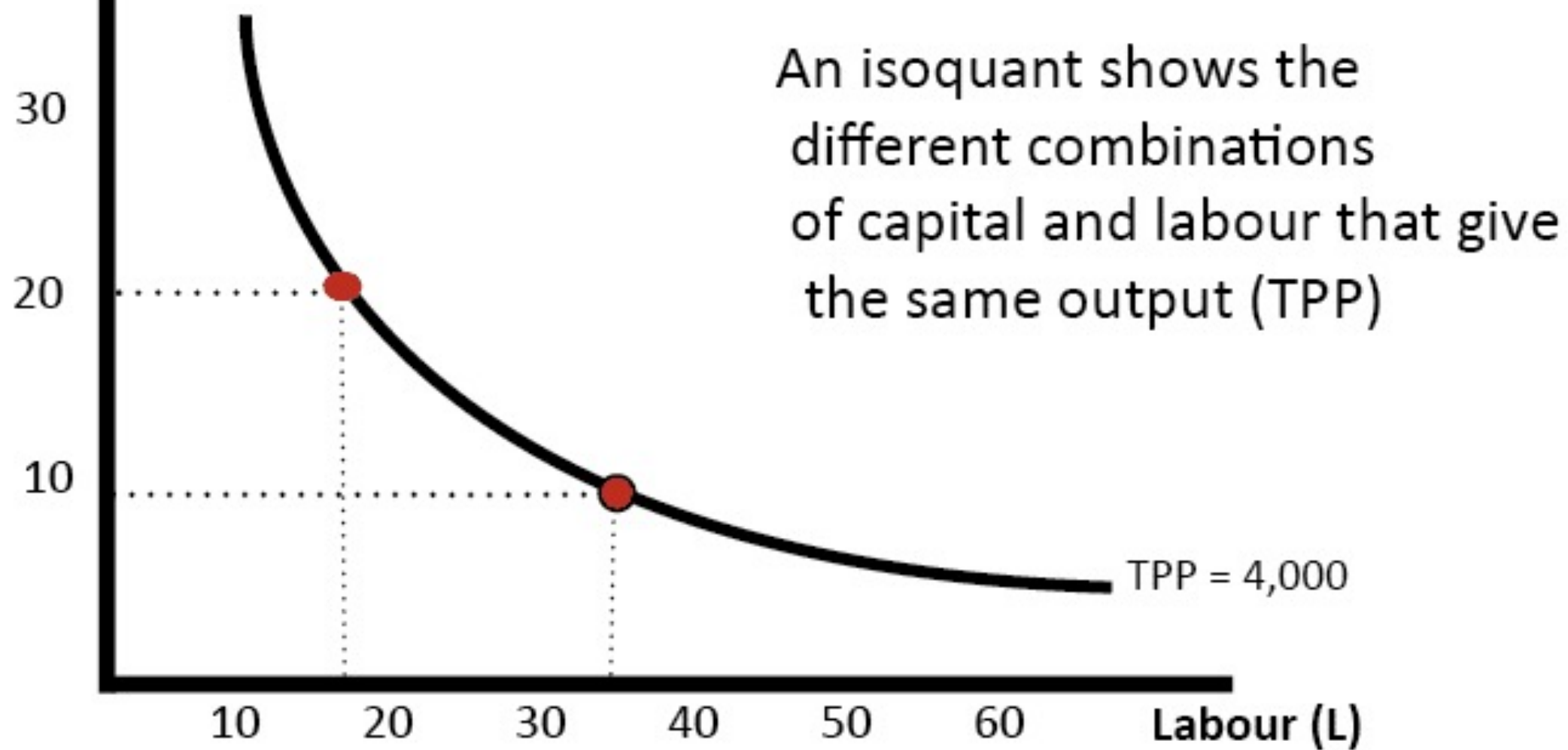
The general production function is $Q = F(L, K)$

Isoquant

- An isoquant, in microeconomics, is a contour line drawn through the set of points at which the **same quantity of output is produced** while **changing the quantities of two or more inputs**.
- An isoquant is **a concave-shaped curve on a graph that measures output**, and the trade-off between two factors needed to keep that output constant. ... The higher and more to the right an isoquant is on a graph, the higher the level of output it represents.
- Two isoquants can not intersect each other.

Capital
(K)

An Isoquant



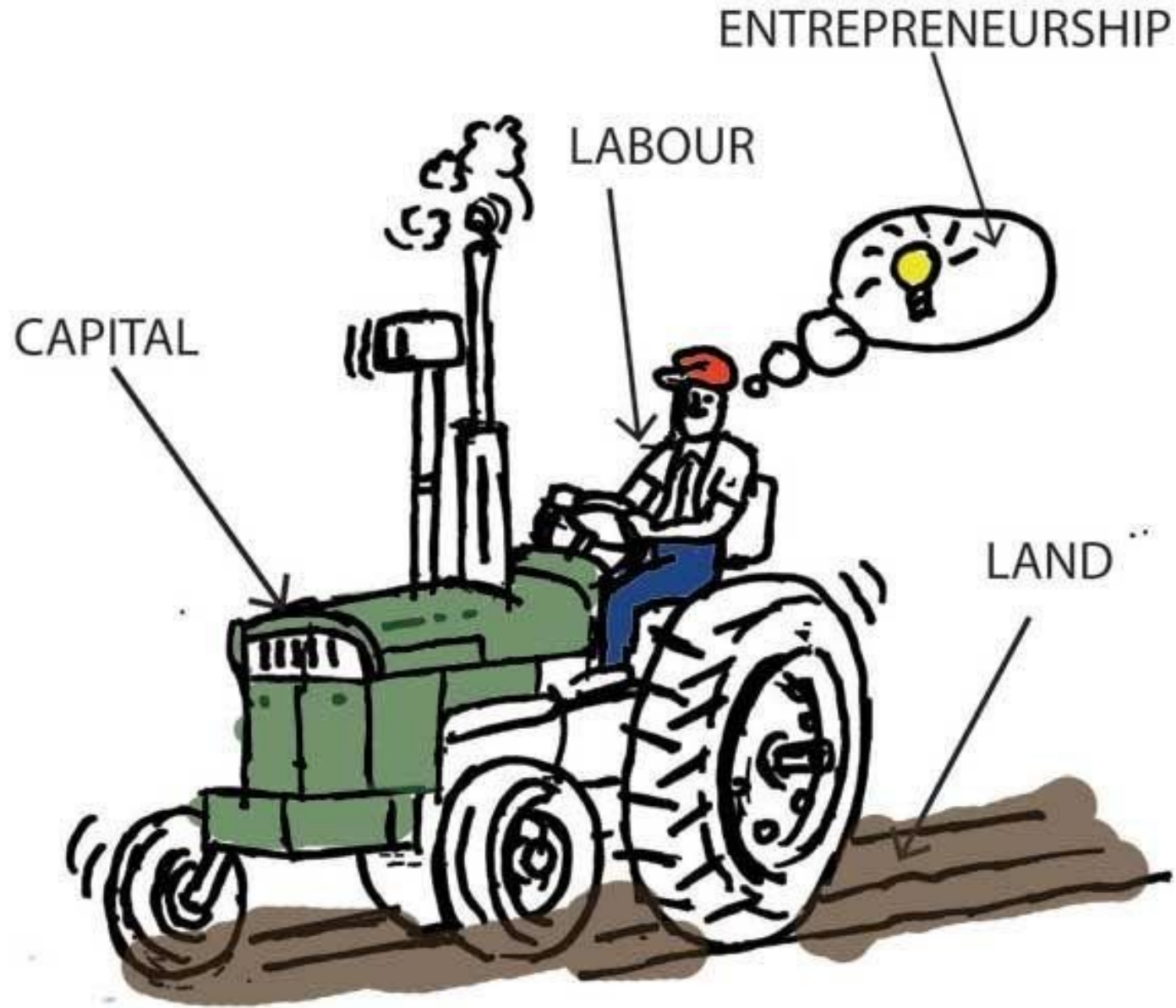
Factors of Production

There are four main factors of production.

1. Land,
2. Labour,
3. Capital and
4. Entrepreneur

The entrepreneur is the one that combines these factors in the correct proportion and mobilizes them.

Factors of Production



(Source: Pinterest)

Factors of Production: Land

- When talking about production, the first factor of production that strikes our mind is land. Interestingly, the economic definition of land does not lie within the limits of just an area.
- A man with little or no knowledge of economics would think of the significance of land as an area required for production. On the contrary, the definition of land in the economics, of course, is an area, but also includes all the free gifts of nature like water, air, natural resources etc. which affect production.
- A factor of production can be a combination of work done by **human efforts** and **natural occurrences**.

Land as a Factor of Production

Free Gift of Nature

- Every factor of production which comes under the umbrella of land should have no supply price. To put it differently, land can be used for production without paying any money to the ultimate owner i.e. the mother earth. Further, it requires no human effort.

Land as a Factor of Production

Fixed Supply

- Land is a strictly fixed factor of production. Obviously, the quantity of land in existence will always remain the same and no human power can alter that. **This means that no amount of change in demand can change the supply of land** - the supply of land is perfectly inelastic.
- However, any free gift of nature is abundant, when seen through the lens of a single firm. Hence, the supply of land is perfectly inelastic from the perspective of an economy whereas it is relatively elastic from the perspective of a single firm.

Land as a Factor of Production

Permanent and has Indestructible Powers

- Most of the features related to land are out of the realms of human power. We can only degrade or upgrade the characteristics of land up to an extent. The quantity of land and specifically the land itself is indestructible.

Immobile

- Of course, land is a static factor. One cannot shift the natural resources from their places of origin. Now some would argue that a factor categorized as land, say water, can be taken to another place. However, you should appreciate the fact that the whole reservoir of water cannot be shifted to another place at will. Further, the combination of natural factors or characteristics of a given place is generally unique.

Land as a Factor of Production

Has Multiple Uses

- We can use land in a variety of ways, for various purposes. Hence, land has multiple uses. However, its suitability for all uses is definitely not the same. For instance, we can use a piece of infertile land to set up a factory but not for cultivation and agriculture.

Heterogeneous - Unique

- Obviously, no two types of land can be the same. There are a plethora of characteristics which define a type of land and two instances of land are bound to differ on at least one of these characteristics. For example, two patches of land can **differ in fertility, dimensions, composition and a lot of other characteristics.**



Factors of Production: Capital

For any business to start and function the first requirement is money. This is the capital of the firm.

It forms the basis of the company and all other factors of production are bought with the capital.

Capital consists of all types of wealth, even the free gifts of nature.

Capital as a Factor of Production

- We can define capital as the productive part of a firm's wealth. Wealth is the sum of **all money, goods, human values** etc. that can be useful in the production of further wealth.
- However, capital is the part of this wealth that is currently in productive use. **Resources lying idle are wealth but not capital.**
- So capital is known as the man-made means of production. Hence capital will include every man-made goods that are used in the production process.
- This differentiates both land and labour from capital since both of these are not man-made. So machinery, tools, plant, instruments, factories, transport vehicles, etc are all forms of capital itself.

Features of Capital

- Capital is a **passive factor of production**. It needs labour to be productive.
- Capital is **variable in nature**. It increases and decreases according to the needs of the firm
- Among all the other factors of production, **capital is the most mobile**. Transportation of capital is an easy activity.
- Also capital is **destructible in nature**. It's not permanent like land. For example, a machine will wear and tear and may even completely break down with time.

Capital Formation

Capital formation essentially means investment.

Increase in
Real Savings

- With an increase in income, there is an increase in savings.
- The government also encourages savings for its citizens. They provide tax benefits and exemptions on saving schemes.
- For an economy both individual savings and government savings are important.



Mobilization
of Savings

- Only saving does not lead to capital formation. These savings have to be mobilized.
- The banks, financial institution, etc collect these savings and offer them to prospective investors. So such institutions and financial products should be available to the public. And they should also be attractive in terms of returns.
- The Govt. will play an important role in the mobilization of savings as well



Investment

- The final step of capital formation.
- Here the real savings get converted to actual investment.
- The entrepreneurs will properly utilize these savings to generate more income and more wealth and the cycle will continue.

Factors of Production: Labour

- Labour actually means any type of physical or mental exertion.
- In economic terms, labour is the efforts exerted to produce any goods or services.
- It includes all types of human efforts – physical exertion, mental exercise, use of intellect, etc. done in exchange for an economic reward.

Characteristics of Labour as a Factor of Production

1] Perishable in Nature

- Labour is perishable in nature. This simply means that it has no storage capacity, i.e. labour cannot be stored. If a worker does not turn up to work for one shift his labour of that shift is lost completely. It cannot be stored and utilized the next day. That labour is lost permanently.
- A laborer cannot store his labour to use at another time. So we say labour as a factor of production is highly perishable.

2] Labour is Inseparable from the Labourer

- This means the **physical presence of the laborer is compulsory**. To sell his services the laborer has to be physically present at the place of production of goods or services. We cannot separate him and his labour power.
- So we cannot expect a welder to do his work from home, he has to present at the site of the work.

Characteristics of Labour as a Factor of Production

3] Human Effort

- Labour is a unique factor of production in comparison with others. It is directly related to human effort, unlike the others. So there are certain special factors we must take into consideration when it comes to labour. **Fair treatment of workers, rest times, suitable work environment, idle time, etc.** are just some such factors.

4] Labour is Heterogeneous

- **We cannot expect labour to be uniform.** Every laborer is unique and so his labour power will also differ from the others.
- The quality and the efficiency of the labour will depend on the skills, work environment, incentives and other inherent qualities of the laborer.

Characteristics of Labour as a Factor of Production

5] Labour has Poor Bargaining Power

- Labour as a factor of production has a very weak bargaining power with the buyer of the services.
- It cannot be stored, isn't very mobile and has no standard or reserve price. So generally laborers are forced to work for whatever wages the employer offers. In comparison to the employer, the laborers have very little bargaining power.
- There is also the problem that laborers do not have any other reserves to fall back on. They are usually poor and ignorant. And this labour work is their only source of income. So they accept whatever wages the employer offers.

Characteristics of Labour as a Factor of Production

6] Not Easily Mobile

- Labour as a factor of production is mobile, i.e. the laborers can relocate to the site of work. But there are many barriers to the movement of labour from one place to another. So we can say labour is not as mobile as some other factors of production like Capital.

7] Supply of Labour is relatively Inelastic

- At any given point in time, the supply of labour in the market is inelastic. It cannot be increased instantly to keep up with the demand. So say there is a shortage of skilled labour in India, skilled laborers cannot be generated in a day, a week or even a year.
- We may be able to import some labour for a short period. But generally, the supply of labour is very inelastic, since we cannot increase or decrease it instantaneously.

Factors of Production: Entrepreneurs

- The entrepreneur is the one that initiates the process of production by mobilizing the other factors of production. He organizes, manages and controls the affairs of the firm. He is the risk bearer and in consideration of this the profit maker as well. Simply put the entrepreneur is the owner of the business.
- However, these are the days of specialization. So we often see a separation between ownership and management. So we now have a different set of functions for the managers and the entrepreneurs.
- The managers take care of the routine day to day decisions. The entrepreneurs focus on the risk bearing and initiating production.

Functions of an Entrepreneur

1] Initiating the Business

- Entrepreneur first identifies the business opportunities or hidden market needs in the economy that he can exploit.
- Then he develops the creative ideas, business model & plan, Project roadmap and decides on the scale of the business.
- Then he integrates the different factors of productions to create, run and grow his business.
- The entrepreneur has to **build up his business dynamically**. He must coordinate the factors of production and utilize them in the right proportions. **The aim is to generate higher productivity (greater outcome for the lowest cost possible) from these factors.**

Functions of an Entrepreneur

2] Risk Bearing

- This is perhaps the most important function of entrepreneurs. The entrepreneurs bear the risks of failure in exchange for the profits of the company. So in dynamic economic model things can change very fast. So the business plans of the entrepreneur should be able to adapt to the changes.
- The consumer taste may change, there can be new entrants in the market, taxes may increase, etc.
- These will all affect the demand and supply of the product. And in turn, the entrepreneur may face some financial losses. Entrepreneurs have to bear these financial risks.
- Then there are technological risks as well. These days we make technological advancements every day. So there is a risk that the product may become obsolete. Or more innovative means of production may be developed. There are other risks such as theft, accidents, etc.
- In exchange for all these risks, the entrepreneurs enjoy the profits earned by the firm. Profit is their reward for bearing the risks. Unlike some of the other management functions, risk bearing cannot be delegated to the manager. The owner/entrepreneurs have to bear all the risk.

Functions of an Entrepreneur

3] Innovation

- One of the other important functions of entrepreneurs is to continuously innovate.
- This innovation can be in the field of new products, new production methods/technology, new business models, exciting and new promotion tactics, exploring new markets, etc.
- However, any new innovation or technology comes with its own share of new risks as well. It will be the job of the entrepreneur to manage such risks in exchange for the scope for higher returns and higher profits.
- Ultimately this innovative spirit of the entrepreneur will lead to advancements in the firm and even the economy as a whole.
- The most successful entrepreneurs are all great innovators – Thomas Edison. ... Steve Jobs. ... Nikola Tesla. ... Elon Musk. ... Bill Gates. ... Benjamin Franklin. ... Leonardo Da Vinci. ... Alexander Graham Bell. ... Sandford Fleming.

Total Product: Total product is the total output obtained from the combined efforts of all the factors of production.

To find the effect of one factor of production, **say labour**, on the total product, we need to keep all the other factors constant. In this case, the total product would vary with the factor kept variable.

Marginal Product: The change in the total product when one more unit is added to the variable factor is known as the marginal product.

Average Product: Average product is the total product per unit of the variable factor. In other words, **it is the ratio of total product to the quantity of variable factor.**

The Relationship between Average Product and Marginal Product

- When there is a rise in the average product due to an increase in the quantity of the variable input, the marginal product is more than the average product.
- The maximum average product is equal to the marginal product. Simply put, the maximum point of the average product curve is also a point on the marginal product curve, a point where both of these curves intersect.
- When the average product falls, the marginal product is less than the average product.
- In other words, the contribution of extra variable inputs is actually nil. This further means that the fixed indivisible factor is being worked too hard. Another reason for the law of diminishing returns is the lack of availability of a perfect substitute.
- In case of the availability of a perfect substitute, an increase in its quantity would have made up for the scarcity of the fixed factor. This, in turn, would have prevented the ineffective utilisation.

Types of Costs

Fixed Costs (FC) The costs which don't vary with changing output. Such as the cost of building a factory, insurance and legal bills.

Even if your output changes or you don't produce anything, your fixed costs remain the same.

Examples of fixed costs:

- Land cost, Rent of building
- Depreciation
- Research and development
- Marketing costs (non-revenue related)
- Administration costs

Types of Costs

Variable Costs (VC) Costs which vary directly with the output produced.

such as raw materials, direct labour, fuel and revenue-related costs such as commission. For example, if you produce more cars, you have to use more raw materials such as metal.

A distinction is often made between "**Direct**" variable costs and "**Indirect**" variable costs.

Direct variable costs are those which can be directly attributable to the production of a particular product or service and allocated to a particular cost centre. Raw materials and the wages those working on the production line are good examples.

Indirect variable costs cannot be directly attributable to production but they do vary with output. These include depreciation (where it is calculated related to output - e.g. machine hours), maintenance and certain labour costs.

Types of Costs

Semi-Variable Cost. Labour might be a semi-variable cost. If you produce more cars, you need to employ more workers; this is a variable cost. However, even if you didn't produce any cars, you may still need some workers to look after an empty factory.

$$\text{Total Costs (TC)} = \text{Fixed} + \text{Variable Costs}$$

Types of Cost: Others

Marginal Costs – Marginal cost is the cost of producing an extra unit. If the total cost of 3 units is 1550, and the total cost of 4 units is 1900. The marginal cost of the 4th unit is 350.

Opportunity Cost – For example, If you invest \$1 million in developing a cure for pancreatic cancer, the opportunity cost is that you can't use that money to invest in developing a cure for skin cancer.

Economic Cost. Economic cost includes both the actual direct costs (accounting costs) plus the opportunity cost. For example, if you take time off work to a training scheme. You may lose a weeks pay of \$350, plus also have to pay the direct cost of \$200. Thus the total economic cost = \$550.

Accounting Costs – this is the monetary outlay for producing a certain good. Accounting costs will include your variable and fixed costs you have to pay.

Types of Cost: Others

Sunk Costs. These are costs that have been incurred and cannot be recouped. If you left the industry, you could not reclaim sunk costs. For example, if you spend money on advertising to enter an industry, you can never claim these costs back. If you buy a machine, you might be able to sell if you leave the industry.

Avoidable Costs. Costs that can be avoided. If you stop producing cars, you don't have to pay for extra raw materials and electricity. Sometimes known as an escapable cost.

Explicit costs – these are costs that a firm directly pays for and can be seen on the accounting sheet. Explicit costs can be variable or fixed, just a clear amount.

Implicit costs – these are opportunity costs, which do not necessarily appear on its balance sheet but affect the firm. For example, if a firm used its assets, like a printing press to print leaflets for a charity, it means that it loses out on revenue from producing commercial leaflets.

BREAK-EVEN ANALYSIS

Determining When a Product Becomes Profitable. In business, your ultimate objective is to make money.

So, when you launch a new product or purchase a new piece of equipment, how do you know whether a potential investment will at least cover the costs associated with it?

Break-even analysis is a technique widely used by production management and management accountants, based on categorising production costs i.e. "variable" (costs that change when the production output changes) and "fixed" (costs not directly related to the volume of production).

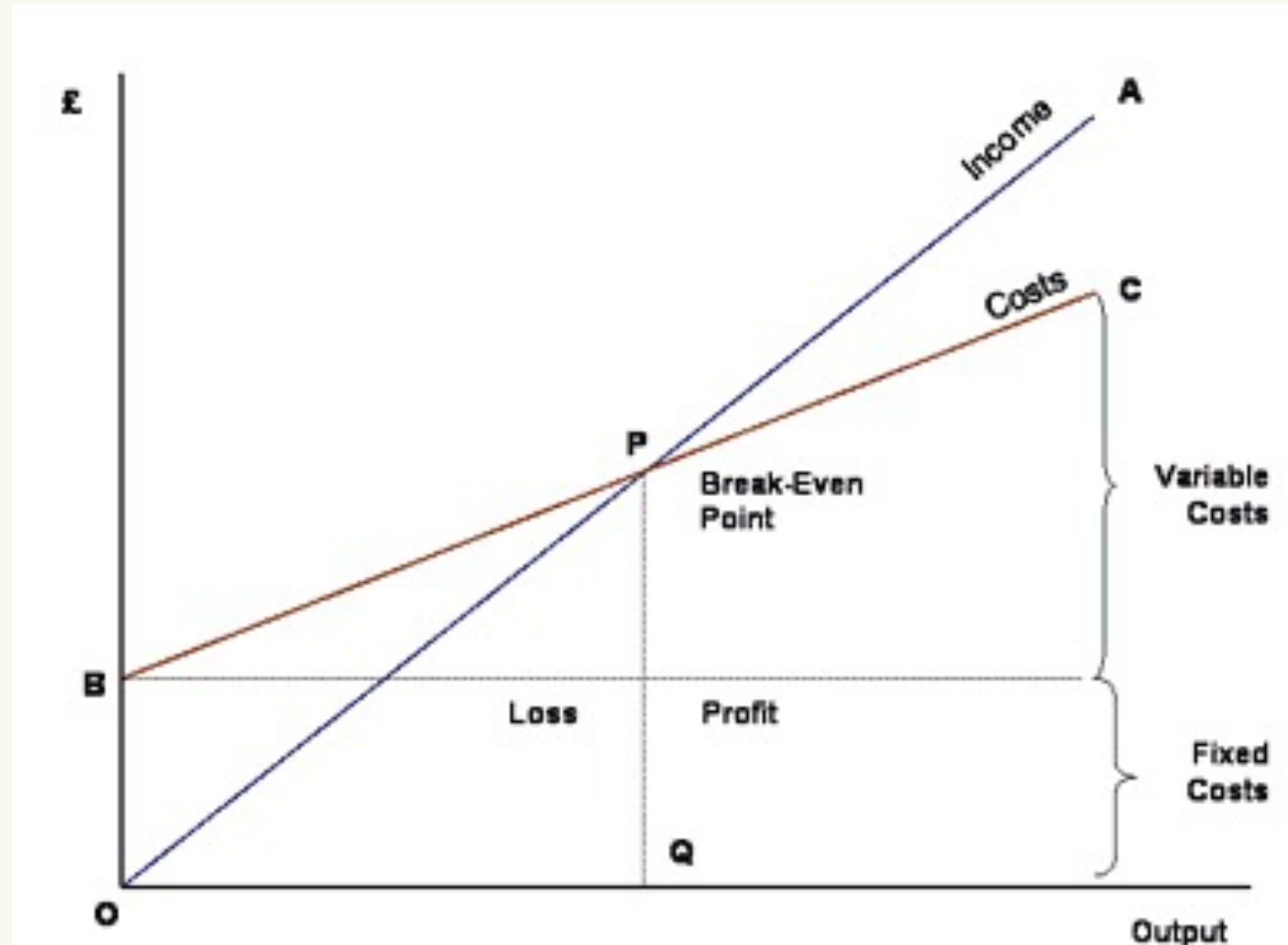
Using a Break-Even Analysis, you can answer questions like:

- What are the projected profits and losses at any given output level?
- At what minimum sales level do you avoid making a loss?
- Do your sales projections for a new product exceed break-even?
- If you drop a product, will your break-even improve?
- How will raising or lowering prices affect your profitability?
- If costs increase, what is the effect on your break-even position?
- How does investing in facility improvements affect your break-even point?

The Break-Even Chart

In the diagram, the line OA represents the variation of income at varying levels of production activity ("output"). OB represents the total fixed costs in the business. As output increases, variable costs are incurred, meaning that total costs (fixed + variable) also increase.

At low levels of output, Costs are greater than Income. At the point of intersection, P, costs are exactly equal to income, and hence neither profit nor loss is made.



Break-Even Point

Break-even point – the level of output at which the revenues generated by a project equal costs. At the break-even point, you don't make or lose money. Once you pass break-even, you make money; below break-even, you lose it.

Break-Even Point = Fixed Costs / (Sales Price Per Unit – Variable Costs Per Unit)

Example: *Company A* sells and manufactures tennis racquets.

They have **fixed costs, total Rs. 250,000** (lease, payroll, property tax, etc.).

The **variable costs** associated with producing tennis racquets are **Rs. 10 per unit**, and **each racquet sells for Rs. 50**.

Company A's break-even point = $250,000 / (50 - 10) = 6,250$

So, Company A would need to sell 6,250 tennis racquets to break even.

Strengths of Break-Even Analysis

- **Pricing** – Break-even analysis gives you a much more solid basis from which **to price your products**. Look at your current financial situation and work out how patient you can afford to be when it comes to reaching your break-even point.
- **Setting revenue targets** – Its a great tool for setting concrete sales targets for your team. If you have **a clear number and a timeframe in place**, you can easily decide upon revenue targets.
- **Mitigate risk** – Sometimes, business ideas just aren't meant to be pursued. Break-even analysis can help you mitigate risk by avoiding investments or product lines that aren't likely to be profitable.
- **Gaining funding** – Break-even analysis is often a key component of business plans. If you want to get funding for your business or start-up, you'll probably need to do a break-even analysis. Plus, a manageable break-even point is likely to make you more comfortable with the prospect of taking on extra financing or debt.

Limitations of Break-Even Analysis

- **Doesn't predict demand** – Although a break-even analysis can tell you when you'll break even, it doesn't give you any insight into how likely that is to happen. Plus, demand isn't stable, so even if you think there's a gap in the market, your break-even point could end up being a lot more ambitious than you initially thought.
- **Depends on reliable data** – In short, the accuracy of your break-even analysis is dependent on the accuracy of your data. If your calculations are wrong or you're dealing with fluctuating costs, break-even analysis may not be the most useful tool in your business.
- **Too simple** – Break-even analysis is best for companies with one price-point. If you have multiple products with multiple prices, then break-even analysis may be too simple for your needs. In addition, it's worth remembering that costs can change, so your break-even point may need to be evaluated and adjusted at a later time.
- **Ignores competition** – Another limitation of a break-even analysis concerns the fact that competitors aren't factored into the equation. New entrants to the market could affect demand for your products or cause you to change your prices, which is likely to affect your break-even point.

Thank
you



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