



The assumption of the break-even chart that level of business activity, product mix, labour productivity and inventory position will remain unchanged is not found in practice. A single chart will fail to mirror the changes in the above state of affairs. For example, when the production mix changes, the existing chart cannot depict the changes. For that, it may be necessary to prepare a separate chart for each product.

Despite the numerous weaknesses of the break-even chart it still continues to be used extensively for two reasons.

First, it shows the relationship between volume, costs and profit in a very effective manner.



Secondly, with a limited range of output within which generally a business operates, the straight lines should tend to approximate the actual position and accordingly, any error that may arise should not be significant.

Significance of Break-Even Analysis as a Tool of Financial Decision Making:

Break-even analysis serves as the most useful and important managerial tool to study cost-output-profits relationships at varying levels of output. This will enable the top management to plan its operational strategies. A finance manager can also make use of this analysis while estimating profits at various levels of sales and production.



Finance manager is not only interested to know at what level of activity the operations of the enterprise will break even but is also interested in estimating the level of operation that will yield optimum profits. Analysis of cost-volume relationships will immensely be useful in profit planning programme.

Finance manager may also use cost-output relationship in establishing or reviewing pricing policies. If the management is contemplating to reduce the price of the product, he may use the relationships to determine what changes in volume of sales would be necessary to compensate the price increase is being considered, the break-even analysis will aid in estimating the maximum reduction in volume that the firm can tolerate without upsetting profitability.



He may also apply this analysis in determining the implications of proposed changes in policies. For example, a 15% increase in wages will definitely raise the break-even point. The break-even chart will clearly portray the approximate increase in output or rise in selling price to obtain the same level of profits before the wage increase. The break-even analysis aids the finance manager in planning the capital structure of his firm.

The analysis provides a good deal of information about the operating risk of the enterprise. Given an estimated break-even point, a finance manager can compare fluctuations in expected future volume with this point to determine the degree of stability of profits. This will enable a finance manager to determine the ability of the firm to service debt.



Such an analysis provides the management with a means to decide whether or not to acquire assets involving additional fixed costs. Finance manager is generally averse to buy an asset requiring additional fixed costs unless sufficient benefits are assured because increase in fixed costs entails the firm in greater operating risk.

A study of change in level of profits following a change in pricing and costs is inevitable to arrive at this sort of decision. The break-even analysis can be used to undertake such study.



Limitations of Break-Even Analysis:

Utility of the break-even analysis can be realised only when it is interpreted wisely and used carefully because the analysis is founded on several unrealistic assumptions. In view of these limitations this technique of financial analysis suffers from the following weaknesses.

Break-even analysis is a short run analysis of cost-volume relationships which will change in correspondence with variation in costs of material and labour and the introduction of new methods of production or with the installation of new equipment. In view of this, such analysis may not prove very useful to rapidly growing companies and to companies which frequently change their product mix or methods of production and whose



material and labour costs change very widely.

The break-even analysis is not suited to deal with cost profit-output relationships in respect of multi-products. A separate break-even analysis for each product has to be used. Then there is also a problem of allocation of expenses which are common to a number of products. In that case it may be an impossible task even to determine the marginal cost.

Another weakness of the break-even analysis is that it does not take due cognizance of factors like uncertainty and risk involved in estimates of costs, volume and profits. As a matter of fact, this analysis is based on historical relationships of cost-profits and output. These relationships may not remain the same over a long period of time.