

What is your business breakeven point?

Do you know what the breakeven sales for your business are? Breakeven sales is the level of sales that your business needs to achieve to cover its fixed (operating) costs. Below this point your business is making a loss and above this point it is making a profit.

For any new business or even an existing business it is important to know what sales you will need to achieve before you reach the breakeven point. Further, if you know where your business is at in relation to the breakeven point, you will be able to make critical decisions in response to changed business conditions.

In order to calculate your breakeven point for your business you need to know the following:

Variable costs (as a percentage of sales). Variable costs are costs that increase or decrease directly in proportion to sales increases or decreases. These include costs of the product you sell, commission paid to sale agents on sales, franchisor royalties if you are franchisee, etc.

Fixed costs. These are the costs that do no change as your sales increase or decrease. These comprise most of your costs such as rent, interest, insurance, wages etc.

Many costs are of course not clearly fixed or clearly variable. If you are able to double the sales of your business then it is likely that wages will increase significantly. However, there will be a sales range within which it is unlikely your wages will change and are relatively fixed.

Lets consider the example of a retail clothing business. The average cost of the product it sells is 60% of the sales price. It has no other variable costs so its contribution margin percentage is 40% (the difference between its sales and its variable costs). All its other costs total \$350,000 per year.

Breakeven point figure is calculated as
$$\frac{\text{Fixed Costs}}{\text{Contribution Margin \%}} = \frac{\$350,000}{40\%} = \$875,000$$

The business therefore needs to make sales of \$875,000 per year, or \$72,917 per month, to breakeven. That is the point at which it will make no profit and no loss.

If your business has not reached its breakeven point, there are three ways to lower your breakeven volume.

- Cut your fixed (operating) expenses. Obviously this should be done with a plan in mind. You can cut too deeply.
- Lower your variable costs - in this case, the cost of the product that is sold. This can be done in a number of ways including better buying, better stock control, taking advantage of early settlement discounts etc.
- Raise prices. Most businesses are reluctant to raise prices because of a fear of a fall-off in sales. Obviously this is a real danger, but the most effective driver of increasing profits is increasing prices.

For example, if the business is turning over \$875,000 and increases its prices by 5% then profit increases by \$43,750 (the full amount of increase in sales) as there is no increase in costs. However, if the business increases sales by 5% the increase in profit is only \$17,500 (the increase in sales of \$43,750 multiplied by the contribution margin of 40%).

You can also use breakeven analysis to help you set targets. Let's assume that the owner of the retail business mentioned above wishes to generate a profit of \$80,000 per year. What sales are required to achieve this profit?

The required sales level is calculated by doing the same calculation as before but adding the amount of desired profit to the fixed costs.


$$\text{Required sales} = \frac{\text{Fixed Costs} + \text{Profit}}{\text{Contribution Margin \%}} = \frac{\$350,000 + \$80,000}{40\%} = \$1,075,000$$

In other words for the business to achieve a profit of \$80,000 per year, sales must be \$1,075,000 per year or \$89,583 per month.

Knowing your breakeven point can also help you in making pricing decisions for your business. Once you have reached breakeven point you can consider selling product (or services) at less than normal prices, because the only additional cost of every sale will be the cost of the product you are selling (and any other variable costs). You have covered all your operating (fixed) costs so selling your product for more than its marginal cost will increase your profit.

Breakeven analysis can be a very useful addition to your business tool-kit.

Your McLean Delmo business services advisor can assist you with breakeven analysis for your business.



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