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THE O'CONNOR GROUP INC.
Business Revitalization

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Does Your Company Utilize Breakeven Analysis?

A company needs to know itself if it expects to be successful. If it does not have accurate knowledge of its own operations and what drives profitability, it cannot look ahead and anticipate changes and/or react appropriately. One of the simplest ways for a company to learn about itself is to perform a Breakeven Analysis on a regular basis.

Regardless of any company's situation, regularly engaging in the B/E analysis provides a roadmap to improvement by highlighting which costs to focus on, where risks truly lie, and what really drives profitability.

What is a Breakeven Analysis?

A Breakeven Analysis (B/E) shows the level of revenue at which a company would break even. It's easy to calculate and is a nice complement to the Profit and Loss Statement (P&L). In fact, it is a reconfiguration of the P&L, but in order to calculate the breakeven point, costs are considered and classified. That part of the exercise yields the most value.

Costs behave differently as output changes. Every company has a level (or levels) of output which maximizes efficiency, thus as output changes, costs increase or decrease disproportionately. B/E analysis illustrates how costs behave.

To determine the B/E point, costs are classified as either fixed or variable. Fixed costs do not change as output changes, at least not in the short term. Examples would be insurance premiums, CEO pay, or compensation of any worker not directly involved in production. Variable costs change as output changes. Examples include raw materials or compensation for production workers/service providers.

For example, consider the quarterly P&L at right. This company's performance improved significantly in 2015 – revenues increased, gross margin improved, and SG&A expenses decreased relative to revenue.

	3/31/2015		3/31/2014	
Gross Revenue	6,837,689		5,097,076	
Returns & Allow.	215,692	3.2%	93,449	1.8%
Net Revenue	6,621,997	96.8%	5,003,628	98.2%
Cost of Goods Sold	5,466,907	80.0%	4,850,133	95.2%
Gross Profit	1,155,089	16.9%	153,495	3.0%
Selling	418,712	6.1%	397,945	7.8%
General/Admin Expenses	260,740	3.8%	256,107	5.0%
Operating Profit	475,637	7.0%	(500,557)	-9.8%
Misc. Expense/(Income)	153,860	2.3%	31,084	0.6%
Net Income	321,777	4.7%	(531,641)	-10.4%

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The P&L only gives a general explanation of why net income improved so dramatically. Analyzing the costs provides a better picture. By analyzing and understanding the costs, a plan was put into place, which led to the improvement. This is how Breakeven Analysis helps.

The company's P&L included about 250 cost accounts spread amongst CGS, Sales, and General/Admin. The first step in making sense of the problems taking place in 2014 was to determine the B/E point. All costs were classified as fixed or variable. Fixed costs totaled $1,658k; variable costs totaled $3,981k.

The Contribution Margin ("CM") was calculated by subtracting the ratio of variable costs to revenue from 1. The CM is a measure of efficiency – it shows what is left of each Revenue dollar after paying variable costs.

In 2014, the CM was only 22%. The B/E point is calculated by dividing Fixed Expenses by the CM. For the company to breakeven in 2014, annual Revenue would have had to be over $30 million. In 2015, this figure dropped to $23 million.

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	3/31/2015	3/31/2014
Gross Income	6,886,014	5,106,657
Variable Expenses	4,838,416	3,980,739
Contribution Margin	29.7%	22.0%
Fixed Expenses	1,725,822	1,657,559
Annual Breakeven Gross Income	**23,215,555**	**30,071,758**
Monthly Breakeven	**1,934,630**	**2,505,980**
Mo. Difference from Prior Year	(571,350)	525,116

How Was Breakeven Analysis Used?

How did the company improve? Fixed costs had remained at the same levels for several years. Analyzing variable costs, however, showed the workforce was operating at low utilization rates in 2014, and further identified a trend of increasing raw materials costs.

Once these factors were identified, the appropriate workforce levels were determined. Prior to completing the analysis, the company decided to increase the workforce by hiring temporary workers whenever orders spiked. In 2015, however, headcount was held steady, and the company achieved unprecedented levels of efficiency. The company also raised prices to offset the raw materials cost increases.

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Both gross profit margin and the contribution margin improved dramatically. The company was able to increase output without increasing workers, and was able to raise prices on its customers.

The B/E analysis shows the drop in the breakeven point. Instead of having to achieve $2.5 million of revenue each month in order to breakeven, the company only had to achieve $1.9 million – a reduction of 24%! It's worth noting that the sharp increase in revenue did not reduce the breakeven point. The breakeven point is only affected by costs - the improvement did not result from revenue growth, but rather by better managing the workforce and operations.

This is good to remember because most companies try to grow year after year. Additional revenue causes margins to change, which the B/E analysis can be used to illustrate. Separating and analyzing costs allows management to see the levels at which economies of scale can be reached.

Fixed costs (i.e. insurance, CEO pay) are static over production ranges, but increasing production to new levels may require leasing additional equipment or hiring a new supervisor. If a management team decides to grow its way out of trouble, B/E clearly shows how much growth is necessary to achieve its goals. It is usually significantly more than anticipated.

B/E analysis is also a great way to see what drives the profits of a business. Companies with low contribution margins get dramatic improvement in profitability by cutting variable costs – i.e. doing the same with less. Likewise, companies with relatively high contribution margins are already efficient. They can dramatically improve profits by cutting fixed costs.

Finally, it also highlights the amount of risk for an entire company or individual business lines. Fixed costs need to be paid no matter what, thus ventures with high fixed costs are relatively risky. The actual and projected returns on these ventures should reflect this.

To learn more about how The O'Connor Group can lay the foundation for your company's future success, please contact **781-275-2423 or info@theoconnorgroup.com**

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