

Cost-Volume-Profit Relationship

Cost-Volume-Profit Relationship. One tool that is very helpful is cost-volume-profit analysis. This gives management the ability to look at relationships of these areas and help improve the bottom line. It also helps in understanding how changes in activity affect contribution margin and net operating income. The contribution margin is calculated by taking the sales minus variable cost. This helps management to isolate the effect of variable cost on sales and to see the impact on profit of different decisions that they might make. The contribution margin income statement begins with the contribution margin formula and then deducts fixed cost to arrive at net operating income. The contribution margin shows management the amount that is remaining to help cover fixed cost. Management can also change amounts to see what the effect would be on other areas. For example, management might want to know what will happen to the bottom line if there is a 10% increase in sales and this statement can help them determine that. The contribution margin ratio, CM ratio is the percentage that the contribution margin is when compared to sales so the percent of every sales dollar that we have left to cover fixed cost. The formula is contribution margin ratio equal contribution margin/sales.