

Reference Text below: Can you indicate what applies to my ques above (if you can)

Any explanation or guidance much appreciated.

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| **Cost Structure and Operating Leverage** |
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**Cost structure** refers to the relative proportion of fixed versus variable costs that a company incurs. Cost structure can have a significant effect on profitability. For example, computer equipment manufacturer Cisco Systems has substantially reduced its fixed costs by choosing to outsource much of its production. While this makes Cisco less susceptible to economic swings, it has also reduced its ability to experience the incredible profitability that it used to have during economic booms.

The choice of cost structure must be carefully considered. There are many ways that companies can influence their cost structure. For example, by acquiring sophisticated robotic equipment, many companies have reduced their use of manual labor. Similarly, some brokerage firms, such asE\*Trade, have reduced their reliance on human brokers and have instead invested heavily in computers and online technology. In so doing, they have increased their reliance on fixed costs (through depreciation on the robotic equipment or computer equipment) and reduced their reliance on variable costs (the variable employee labor cost). Alternatively, some companies have reduced their fixed costs and increased their variable costs by outsourcing their production. Nike, for example, does very little manufacturing, but instead outsources the manufacture of nearly all of its shoes. It has consequently converted many of its fixed costs into variable costs and therefore changed its cost structure.

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| **study objective 5** |

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| **Understand how operating leverage affects profitability.** |

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Consider the following example of Vargo Video and one of its competitors, New Wave Company. Both make DVD players. Vargo Video uses a traditional, labor-intensive manufacturing process. New Wave Company has invested in a completely automated system. The factory employees are involved only in setting up, adjusting, and maintaining the machinery. Illustration 19-21 shows CVP income statements for each company.

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| **Illustration 19-21** | CVP income statements for two companies |

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Both companies have the same sales and the same net income. However, because of the differences in their cost structures, they differ greatly in the risks and rewards related to increasing or decreasing sales. Let's evaluate the impact of cost structure on the profitability of the two companies.

EFFECT ON CONTRIBUTION MARGIN RATIO

First let's look at the contribution margin ratio. Illustration 19-22 shows the computation of the contribution margin ratio for each company.

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| **Illustration 19-22** | Contribution margin ratio for two companies |

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New Wave has a contribution margin ratio of 80% versus only 40% for Vargo. That means that with every dollar of sales, New Wave generates 80 cents of contribution margin (and thus an 80 cent increase in net income), versus only 40 cents for Vargo. However, it also means that for every dollar that sales decline, New Wave loses 80 cents in net income, whereas Vargo will lose only 40 cents. New Wave's cost structure, which relies more heavily on fixed costs, makes it more sensitive to changes in sales revenue.

EFFECT ON BREAK-EVEN POINT

The difference in cost structure also affects the break-even point. The break-even point for each company is calculated in Illustration 19-23.

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| **Illustration 19-23** | Computation of break-even point for two companies |

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New Wave needs to generate $150,000 ($650,000 - $500,000) more in sales than Vargo before it breaks even. This makes New Wave riskier than Vargo because a company cannot survive for very long unless it at least breaks even.

EFFECT ON MARGIN OF SAFETY RATIO

We can also evaluate the relative impact that changes in sales would have on the two companies by computing the margin of safety ratio. Illustration 19-24 shows the computation of the **margin of safety ratio** for the two companies.

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| **Illustration 19-24** | Computation of margin of safety ratio for two companies |

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The difference in the margin of safety ratio also reflects the difference in risk between the two companies. Vargo could sustain a 38% decline in sales before it would be operating at a loss. New Wave could sustain only a 19% decline in sales before it would be “in the red.”

OPERATING LEVERAGE

**Operating leverage** refers to the extent to which a company's net income reacts to a given change in sales. Companies that have higher fixed costs relative to variable costs have higher operating leverage. When a company's sales revenue is increasing, high operating leverage is a good thing because it means that profits will increase rapidly. But when sales are declining, too much operating leverage can have devastating consequences.

**Degree of Operating Leverage**

How can we compare operating leverage between two companies? The **degree of operating leverage** provides a measure of a company's earnings volatility and can be used to compare companies. Degree of operating leverage is computed by dividing contribution margin by net income. This formula is presented in Illustration 19-25 and applied to our two manufacturers of DVD players.

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| **Illustration 19-25** | Computation of degree of operating leverage |

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New Wave's earnings would go up (or down) by about two times (5.33 ÷ 2.67 = 1.99) as much as Vargo's with an equal increase (or decrease) in sales. For example, suppose both companies experience a 10% decrease in sales. Vargo's net income will decrease by 26.7% (2.67 × 10%), while New Wave's will decrease by 53.3% (5.33 × 10%). Thus, New Wave's higher operating leverage exposes it to greater earnings volatility risk.

You should be careful not to conclude from this analysis that a cost structure that relies on higher fixed costs, and consequently has higher operating leverage, is necessarily bad. When used carefully, operating leverage can add considerably to a company's profitability. For example, computer equipment manufacturer Komag enjoyed a 66% increase in net income when its sales increased by only 8%. As one commentator noted, “Komag's fourth quarter illustrates the company's significant operating leverage; a small increase in sales leads to a big profit rise.” However, as our illustration demonstrates, increased reliance on fixed costs increases a company's risk.

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|  | Rexfield Corp. is contemplating a huge investment in automated mass-spectrometers for its medical laboratory testing services. Its current process relies heavily on the expertise of a high number of lab technicians. The new equipment would employ a computer expert system that integrates much of the decision process and knowledge base that is used by a skilled lab technician.Rex Field, the company's CEO, has requested that an analysis of projected results using the old technology versus the new technology be done for the coming year. The accounting department has prepared the following CVP income statements for use in your analysis.

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|   | **Old** | **New** |
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| Sales revenue | $2,000,000 | $2,000,000 |
| Variable costs | 1,400,000 | 600,000 |
| Contribution margin | 600,000 | 1,400,000 |
| Fixed costs | 400,000 | 1,200,000 |
| Net income | $  200,000 | $  200,000 |

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**Instructions**Use the information provided above to do the following.

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| **(a)** | Compute the degree of operating leverage for the company under each scenario, and discuss your results. |
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| **(b)** | Compute the break-even point in dollars and margin of safety ratio for the company under each scenario, and discuss your results. |

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**Solution**

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| **(a)** |

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|   | Contribution Margin | ÷ | Net Income | = | Degree of Operating Leverage |
| Old |   $600,000 | ÷ | $200,000 | = | 3 |
| New | $1,400,000 | ÷ | $200,000 | = | 7 |

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The degree of operating leverage measures the company's sensitivity to changes in sales. By switching to a cost structure dominated by fixed costs, the company would significantly increase its operating leverage. As a result, with a percentage change in sales, its percentage change in net income would be 2.33 times as much (7 ÷ 3) under the new structure as it would under the old. |
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| **(b)** | To compute the break-even point in sales dollars, we need first to compute the contribution margin ratio under each scenario. Under the old structure the contribution margin ratio would be .30 ($600,000 ÷ $2,000,000), and under the new it would be .70 ($1,400,000 ÷ $2,000,000).

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|   | Fixed Costs | ÷ | Contribution Margin Ratio | = | Break-even Point in Dollars |
| Old | $400,000 | ÷ | .30 | = | $1,333,333 |
| New | $1,200,000 | ÷ | .70 | = | $1,714,286 |

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Because the company's fixed costs would be substantially higher under the new cost structure, its break-even point would increase significantly, from $1,333,333 to $1,714,286. A higher break-even point is riskier because it means that the company must generate higher sales to be profitable.The margin of safety ratio tells how far sales can fall before the company is operating at a loss.

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Under the old structure, sales could fall by 33% before the company would be operating at a loss. Under the new structure, sales could fall by only 14%. |

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