Management Accounting

PRACTICAL CLASS 17

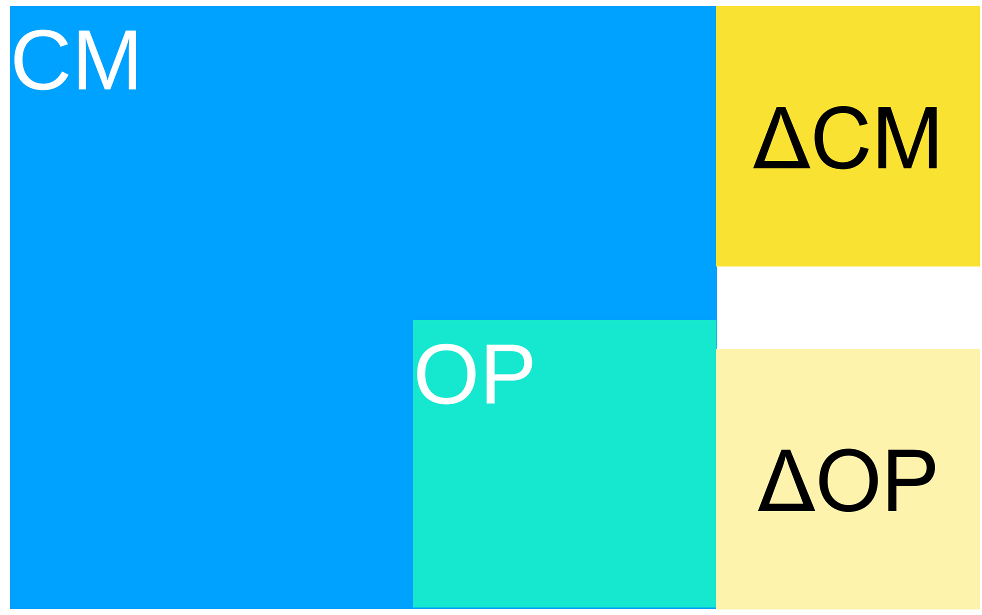
Illustration by Ana Seixas

Operating Leverage

NOTHING BUT SOME QUICK ALGEBRA

Operating leverage, as in the name, means *leverage: the good gets greater, but the bad gets a lot worse ☺, i.e, when sales are expanding, your profits grow a lot faster, but when sales are very low, losses can be very severe.*

In essence, since the CM is larger than the Operating profit, the % impact on profits will be much higher in the OP than in the CM, and the DOL is the "adjustment factor" for it.



Measures how sensitive profit is to a change in the value of Sales/Contribution Margin

$$\text{Degree of Operating Leverage} = \frac{\text{Contribution Margin}}{\text{Operating Profit}}$$

High Operating Leverage: Most of the costs are fixed.

E.g: *Airlines, Automotive Companies, Mining, Utilities, Hotels*

Low Operating Leverage: Most of the costs are variable.

E.g: *restaurants, retailers, small services, free-lancing work*

High Operating Leverage ➞ High Profit Volatility

*A x% increase in the Contribution Margin reflects into a (x% * DOL) % increase in the Operating Profit*

Classification

RELEVANT

Opportunity Cost	Benefit of the best alternative that was sacrificed
Avoidable Costs	Costs that can be saved by not adopting an alternative
Future Outlay Cost	Costs that vary with the decision

IRRELEVANT

Sunk Cost	Past costs that cannot be changed by any current or future action
Unavoidable Cost	Costs that cannot be saved by pursuing an alternative
Committed Cost	Costs that are agreed in the future and cannot be changed

Exercise 46

ARMAZÉNS POPULARES

Exercise 51

THE CANOEX COMPANY

Exercise 52

THE INDUSTRIAL COMPANY