

The Nature of Costs

Multiple Choice Questions

1. Opportunity Costs:
 - A. must never be negative
 - B. may be found in financial statements (annual report)
 - C. reflect the benefit of the next best alternative
 - D. are pecuniary in nature
 - E. none of the above

2. John invested \$12,000 in the stock of Hyper Cyber Eight years later, Hyper Cyber's shares reached \$125,000, but John held onto the shares in the belief that their price would double in the next five years. Unfortunately, Hyper Cyber did not double. Rather the market value of John's shares today is \$4,000. If the shares were sold and the proceeds invested in another investment, they would likely earn 5% per annum. Which of the following terms and values is correct?
 - A. \$125,000 is the opportunity cost of selling the shares today
 - B. \$12,000 is a sunk cost
 - C. \$250,000 is the opportunity cost
 - D. \$2000 is the opportunity cost
 - E. None of the above

3. Which of the following can be an opportunity cost?

- A. Interest on cost of inventory
- B. Cost of idle capacity
- C. Cost of underutilized labor
- D. The decline in an asset's value
- E. All of the above

4. Davos Inc. makes fiberglass ski-boards in Switzerland. Identify the correct matching of terms.

- A. Fiberglass is factory overhead
- B. Plant real estate taxes are a period cost
- C. Depreciation on delivery trucks is a product cost
- D. Payroll taxes for workers in the Packaging Department are direct labor
- E. None of the above

5. Pamela in Bamplona makes bull-repellent scent according to a traditional Spanish recipe, which normally sells at €9 (Euros) per unit. Normal production volume is 10,000 ounces per month. Average cost is €5 per ounce, of which €2 is direct material and €1 is variable conversion cost. This product is seasonal. After July, demand for this product drops to 6,000 ounces monthly. In November, Umberto offers to buy 1,500 ounces for €6,000.

If Pamela accepts the order, she must design a special label for Umberto at a cost of €500. Each label will cost 25 cents to make and apply. Pamela should:

- A. accept the order, at a gain of €625
- B. reject the order, at a loss of €1,875
- C. reject the order, at a loss of €2,375
- D. accept the order, at a gain of €1,125
- E. none of the above

6. Pamela in Bamplona makes bull-repellent scent according to a traditional Spanish recipe, which normally sells at €9 (Euros) per unit. Normal production volume is 10,000 ounces per month. Average cost is €5 per ounce, of which €2 is direct material and €1 is variable conversion cost. This product is seasonal. After July, demand for this product drops to 6,000 ounces monthly. In November, Umberto offers to buy 1,500 ounces for €6,000.

Now assume that the order is received in July, peak season. If Pamela accepts the order, she will turn away regular customers who order 500 ounces. Pamela should:

- A. reject the order, which loses €1,875
 - B. reject the order as it is less than her cost
 - C. accept the order if Umberto raises the price higher than €6.58/ounce
 - D. accept the order if Umberto raises the price higher than €5.58/ounce
 - E. none of the above
7. Francois French manufactures cheese, which he normally sells at €20/kg, on which sales commission of 5% is paid. Plant capacity is 7,500 kg/month. Income tax is levied at 30%.

| Fixed costs | | Costs per kg. | |
|--------------------|--------|------------------|----|
| Plant depreciation | €8,000 | Direct materials | €4 |
| Other plant costs | 15,000 | Direct labor | 2 |
| Corporate salaries | 10,000 | Var. factory O/H | 3 |
| Advertising | 3,000 | | |

The number of kilograms to sell to break-even is:

- A. 3,273
- B. 3,600
- C. 3,000
- D. 2,300
- E. none of the above

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| Advertising | 3,000 | | |

If sales are 5,000 kgs, which of the following is true?

- A. Total contribution margin is €50,000
- B. Ratio of total contribution margin to net income before taxes is 3.57
- C. Taxes payable are €4,200
- D. Operating leverage is 42%
- E. All of the above

9. Francois French manufactures cheese, which he normally sells at €20/kg, on which sales commission of 5% is paid. Plant capacity is 7,500 kg/month. Income tax is levied at 30%.

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| Advertising | 3,000 | | |

Francois French wants to increase after-tax profits to €35,000. Assuming sufficient demand, which strategy achieves this goal?

- A. Sell 7,100 kgs at the present price
 - B. Pay the dairy €1/kg less and sell 7,500 kgs
 - C. Sell 8,000 kgs at €20.79/kg
 - D. Sell 7,500 kgs at the present price and eliminate the sales commission
 - E. None of the above
10. The Mojave Water Agency (MWA) sets water policy and water rates for a desert area that faces a severe water shortage. It has 200,000 customers who are charged \$100 per month for the first 20,000 cubic feet (cu.ft) and 1 cent per cu.ft thereafter. The average customer bill is \$200 per month. It costs the agency ¼ cent per cu.ft to monitor and bill for usage. The MWA wants to cut costs by replacing metered billing with a flat fee which would be added to each property owner's real estate tax bill. Which is true?
- A. The proposed policy will be more expensive to operate and will lead to decreased water usage
 - B. The proposed policy will be cheaper to operate and will lead to increased water usage
 - C. The proposed policy will be cheaper to operate and will lead to decreased water usage
 - D. The most that the MWA should pay the County Real Estate Department for handling the proposed billing process is \$6,000,000
 - E. b) and d) above

11. Hardley sells mamburgers. He faces fixed costs of \$18,000 per month and variable production and marketing costs of \$2 per mamburger. Market research has developed the following demand schedule. Which price/volume combination should Yardley choose?

- A. Price: \$12; Quantity: 4,000
- B. Price: \$10; Quantity: 5,500
- C. Price: \$8; Quantity: 7,000
- D. Price: \$6; Quantity: 9,000
- E. Unable to determine

12. Bertie's Burritos, a fast food enterprise, wants to understand his cost structure. He collected data, which appears below, to analyze costs using the high-low method.

| Month | Volume | Total costs |
|----------|--------|-------------|
| January | 5,000 | \$2,700 |
| February | 7,000 | \$3,700 |
| March | 6,000 | \$3,400 |

Which is true?

- A. Estimated variable costs are 70 cents per burrito
- B. Fixed costs cannot be estimated
- C. Estimated fixed costs are \$200
- D. Total costs at volume of 8,000 are estimated at \$4,200
- E. c) and d) only

Essay Questions

13. Fixed, Variable, and Average Costs

Midstate University is trying to decide whether to allow 100 more students into the university. Tuition is \$5,000 per year. The controller has determined the following schedule of costs to educate students:

| Number of Students | Total Costs |
|--------------------|--------------|
| 4,000 | \$30,000,000 |
| 4,100 | 30,300,000 |
| 4,200 | 30,600,000 |
| 4,300 | 30,900,000 |

The current enrollment is 4,200 students. The president of the university has calculated the cost per student in the following manner: $\$30,600,000 / 4,200 \text{ students} = \7286 per student. The president was wondering why the university should accept more students if the tuition is only \$5,000.

Required:

- What is wrong with the president's calculation?
- What are the fixed and variable costs of operating the university?

14. The Elements of Cost Volume Profit

The M Company's variable costs are 75% of the sales price per unit and their fixed costs are \$240,000. If the company earned \$60,000 before taxes in selling 150,000 units, what was the sales price per unit?

15. Opportunity Costs

The First Church has been asked to operate a homeless shelter in part of the church. To operate a homeless shelter the church must hire a full time employee for \$1,200/month to manage the shelter. In addition, the church would have to purchase \$400 of supplies/month for the people using the shelter. The space that would be used by the shelter is rented for wedding parties. The church averages about 5 wedding parties a month that pay rent of \$200 per party. Utilities are normally \$1,000 per month. With the homeless shelter, the utilities will increase to \$1,300 per month.

What is the opportunity cost to the church of operating a homeless shelter in the church?

16. Fixed and Variable Costs:

The university athletic department has been asked to host a professional basketball game at the campus sports center. The athletic director must estimate the opportunity cost of holding the event at the sports center. The only other event scheduled for the sports center that evening is a fencing match that would not have generated any additional costs or revenues. The fencing match can be held at the local high school, but the rental cost of the high school gym would be \$200. The athletic director estimates that the professional basketball game will require 20 hours of labor to prepare the building. Clean-up depends on the number of spectators. The athletic director estimates the time of clean-up to be 2 minutes per spectator. The labor would be hired especially for the basketball game and would cost \$16 per hour. Utilities will be \$500 greater if the basketball game is held at the sports center. All other costs would be covered by the professional basketball team.

Required:

- a. What is the variable cost of having one more spectator?
- b. What is the opportunity cost of allowing the professional basketball team to use the sports center if 10,000 spectators are expected?
- c. What is the opportunity cost of allowing the professional basketball team to use the sports center if 12,000 spectators are expected?

17. Opportunity Cost of Attracting Industry

The Itagi Computer Company from Japan is looking to build a factory for making Wi-Fi routers in the United States. The company is concerned about the safety and well-being of its employees and wants to locate in a community with good schools. The company also wants the factory to be profitable and is looking for subsidies from potential communities. Encouraging new business to create jobs for citizens is important for communities, especially communities with high unemployment.

Wellville has not been very well since the shoe factory left town. The city officials have been working on a deal with Itagi to get the company to locate in Wellville. Itagi officials have identified a 20 acre undeveloped site. The city has tentatively agreed to buy the site for \$50,000 for Itagi and not require any payment of property taxes on the factory by Itagi for the first five years of operation. The property tax deal will save Itagi \$3,000,000 in taxes over the five years. This deal was leaked to the local newspaper. The headlines the next day were: "Wellville Gives Away \$3,000,000 + to Japanese Company".

Required:

- a. Do the headlines accurately describe the deal with Itagi?
- b. What are the relevant costs and benefits to the citizens of Wellville of making this deal?

18. Cost, Volume, Profit Analysis

With the possibility of the US Congress relaxing timber cutting restrictions, a local lumber company is considering an expansion of its facilities. The company believes it can sell lumber for \$0.18/board foot. A board foot is a measure of lumber. The tax rate for the company is 30 percent. The company has the following two opportunities:

- Build Factory A with annual fixed costs of \$20 million and variable costs of \$0.10/board foot. This factory has an annual capacity of 500 million board feet.
- Build Factory B with annual fixed costs of \$10 million and variable costs of \$0.12/board foot. This factory has an annual capacity of 300 million board feet.

Required:

- a. What is the break-even point in board feet for Factory A?
- b. If the company wants to generate an after tax profit of \$2 million with Factory B, how many board feet would the company have to process and sell?
- c. If demand for lumber is uncertain, which factory is riskier?
- d. At what level of board feet would the after-tax profit of the two factories be the same?

19. Cost, Volume, Profit Analysis

Leslie Mittelberg is considering the wholesaling of a leather handbag from Kenya. She must travel to Kenya to check on quality and transportation. The trip will cost \$3,000. The cost of the handbag is \$10 and shipping to the United States can occur through the postal system for \$2 per handbag or through a freight company which will ship a container that can hold up to a 1,000 handbags at a cost of \$1,000. The freight company will charge \$1,000 even if less than 1,000 handbags are shipped. Leslie will try to sell the handbags to retailers for \$20. Assume there are no other costs and benefits.

Required:

- a. What is the break-even point shipping through the postal system?
- b. How many units must be sold if Leslie uses the freight company and she wants to have a profit of \$1,000?
- c. At what output level would the two shipping methods yield the same profit?
- d. Suppose a large discount store asks to buy an additional 1,000 handbags beyond normal sales. Which shipping method should be used and what is the minimum sales price Leslie should consider in selling those 1,000 handbags?

20. Multiple Product Cost Volume Profit

A company sells three products as shown below:

| | Product X | Product Y | Product Z | Total |
|------------------------|--------------|--------------|--------------|-----------|
| Units | 60,000 | 140,000 | 50,000 | 250,000 |
| Sales | \$90,000 | \$150,000 | \$60,000 | \$300,000 |
| Variable Costs | \$63,000 | \$93,000 | \$19,000 | \$175,000 |
| Contribution Margin | | | | \$125,000 |
| Fixed Costs | | | | \$100,000 |

These three products all always sold in fixed proportions. In other words, Product X always accounts for 24% of total sales (60,000/250,000), Product Y always accounts for 56% of total sales (140,000/250,000), and Product Z always accounts for 20% of total sales (50,000/250,000).

Required:

- How many units of each product need to be sold to break-even?
- How many units must of each product must be sold if the company wants to have a profit of \$50,000?

21. Make or Buy

A company needs 10,000 units of a component used in producing one of its products. The latest internal accounting reports show that the per unit manufacturing cost to be \$150.00, variable manufacturing costs of \$110.00 and fixed manufacturing cost of \$40. The company recently received an offer from another manufacturer to produce the component for \$144.00. If it buys the component on the outside 40% of the fixed manufacturing cost can be avoided.

Required:

- a. If the company buys the component from the outside supplier at \$144.00, what is the impact on income?
- b. What price would make the company indifferent between making the component internally and having the outside supplier make it?

22. Cost, Volume, Profit Analysis

Easy Go Company manufactures a line of electric garden tools that are sold in general hardware stores. The company's controller, Amy Tait, has just received the sales forecast for the coming year for Easy Go's three products: weeders, hedge clippers, and leaf blowers. Easy Go has experienced considerable variations in sales volumes and variable costs over the past two years, and Harlow believes the forecast should be carefully evaluated from a cost-volume-profit viewpoint. The preliminary budget information for the next year is presented below.

| | Weeders | Hedge Clippers | Leaf Blowers |
|--|---------|-------------------|-----------------|
| Unit sales | 50,000 | 50,000 | 100,000 |
| Unit selling price | \$28.00 | \$36.00 | \$48.00 |
| Variable manufacturing cost per unit | 13.00 | 12.00 | 25.00 |
| Variable selling cost per unit | 5.00 | 4.00 | 6.00 |

For the next year, Easy Go's fixed factory overhead is budgeted at \$2 million, and the company's fixed selling and administrative expenses are forecast to be \$600,000. Easy Go has a tax rate of 40 percent.

Required:

- Determine Easy Go Co.'s budgeted net income for next year.
- Assuming that the sales mix remains as budgeted, determine how many units of each product Easy Go must sell in order to break even next year.
- Determine the total dollar sales Easy Go must sell next year in order to earn an after-tax net income of \$450,000.
- After preparing the original estimates, Easy Go determines that its variable manufacturing cost of leaf blowers will increase 20 percent and the variable selling cost of hedge clippers can be expected to increase \$1 per unit. However, Easy Go has decided not to change the selling price of either product. In addition, Easy Go learns that its leaf blower is perceived as the best value on the market, and it can expect to sell three times as many leaf blowers as any other product. Under these circumstances, determine how many units of each product Easy Go will have to sell to break even in next year.
- Explain the limitations of cost-volume-profit analysis that Amy Tait should consider when

evaluating Easy Go's next year's budget.

23. Break-even and Cost-Volume-Profit with Taxes

DisKing Company sells used DVDs on line. The projected after-tax net income for the current year is \$120,000 based on a sales volume of 200,000 DVDs. DisKing has been selling the disks at \$16 each. The variable costs consist of the \$10 unit purchase price of the disks and a handling cost of \$2 per disk. DisKing's annual fixed costs are \$600,000 and DisKing is subject to a 40 percent income tax rate.

Required:

- a. Calculate DisKing Company's break-even point for the current year in number of DVDs.
- b. Calculate the increased after-tax income for the current year if projected unit sales volume increase 10 percent.
- c. Management expects that the price DisKing pays for used DVDs to increase 30 percent next year. If the unit selling price remains at \$16, calculate the volume of sales in dollars that DisKing Company must achieve in the coming year to maintain the same after-tax net income as projected for the current year.

24. Cost-Volume-Profit of a Make/Buy Decision

Telly Industries is a multiproduct company that currently manufactures 30,000 units of Part MR24 each month. The facilities now being used to produce Part MR24 have a fixed monthly cost of \$150,000 and a capacity to produce 84,000 units per month. If Telly were to buy Part MR24 from an outside supplier, the facilities would be idle, but its fixed costs would continue at 40 percent of its present amount. The variable production costs of Part MR24 are \$11 per unit.

Required:

- a. If Telly Industries continues to use 30,000 units of Part MR24 each month, it would realize a net benefit by purchasing Part MR24 from an outside supplier only if the supplier's unit price is less than how much?
- b. If Telly Industries can obtain Part MR24 from an outside supplier at a unit purchase price of \$12.875, what is the monthly usage at which it will be indifferent between purchasing and making Part MR24?

25. Opportunity Cost of Purchase Discounts and Lost Sales

Spring Company manufactures hard drives for computer manufacturers. At the beginning of this year Spring began shipping a much-improved hard drive, Model W899. The W899 was an immediate success and accounted for \$5 million in revenues for Spring this year.

While the W899 was in the development stage, Spring planned to price it at \$130. In preliminary discussions with customers about the W899 design, no resistance was detected to suggestions that the price might be \$130. The \$130 price was considerably higher than the estimated variable cost of \$70 per unit to produce the W899, and it would provide Spring with ample profits.

Shortly before setting the price of the W899, Spring discovered that a competitor had a product very similar to the W899 and was no more than 60 days behind Spring's own schedule. No information could be obtained on the competitor's planned price, although it had a reputation for aggressive pricing. Worried about the competitor, and unsure of the market size, Spring lowered the price of the W899 to \$100. It maintained the price although, to Spring's surprise, the competitor announced a price of \$130 for its product.

After reviewing the current year's sales of the W899, Spring's management concluded that unit sales would have been the same if the product had been marketed at the original price of \$130 each. Management has predicted that next year's sales of the W899 would be either 85,000 units at \$100 each or 60,000 units at \$130 each. Spring has decided to raise the price of the disk drive to \$130 effective immediately.

Having supported the higher price from the beginning, Sharon Haley, Spring's marketing director, believes that the opportunity cost of selling the W899 for \$100 should be reflected in the company's internal records and reports. In support of her recommendation, Haley explained that the company has booked these types of costs on other occasions when purchase discounts not taken for early payment have been recorded.

Required:

- a. Define *opportunity cost* and explain why opportunity costs are not usually recorded.
- b. What is the current year's opportunity cost?
- c. Explain the impact of Spring Company's selection of the \$130 selling price for the W899 on next year's operating income. Support your answer with appropriate calculations.

26. Make/Buy and the Opportunity Cost of Freed Capacity

Zelean Manufacturing uses 10 units of part KJ37 each month in the production of radar equipment. The cost to manufacture one unit of KJ37 is presented in the accompanying table.

| | |
|--|-----------------|
| Direct materials | \$1,000 |
| Materials handling (20% of direct material cost) | 200 |
| Direct labor | 8,000 |
| Manufacturing overhead | 12,000 |
| Total manufacturing cost | <u>\$21,200</u> |

Materials handling represents the direct variable costs of the receiving department and is applied to direct materials and purchased components on the basis of their cost. This is a separate charge in addition to manufacturing overhead. Zelean's annual manufacturing overhead budget is one-third variable and two-third fixed. Scott Supply, one of Zelean's reliable vendors, has offered to supply part KJ37 at a unit price of \$15,000. The fixed cost of producing KJ37 is the cost of a special piece of testing equipment that ensures the quality of each part manufactured. This testing equipment is under a long-term, noncancelable lease. If Zelean were to purchase part KJ37, materials handling costs would not be incurred.

Required:

- If Zelean purchases the KJ37 units from Scott, the capacity Zelean was using to manufacture these parts would be idle. Should Zelean purchase the parts from Scott? Make explicit any key assumptions.
- Assume Zelean Manufacturing is able to rent all idle capacity for \$25,000 per month. Should Zelean purchase from Scott Supply? Make explicit any key assumptions.
- Assume that Zelean Manufacturing does not wish to commit to a rental agreement but could use idle capacity to manufacture another product that would contribute \$52,000 per month. Should Zelean manufacture KJ37? Make explicit any key assumptions.

27. "Price gouging" or increased opportunity cost?

After the Iraqi invasion of Kuwait in August 1990, the world price of crude oil doubled to more than \$30 per barrel in anticipation of reduced supply. Immediately, the oil companies raised the retail price on refined oil products even though these products were produced from oil purchased at the earlier, lower prices. The media charged the oil companies with profiteering and price gouging, and politicians promised immediate investigations.

Required:

Critically evaluate the charge that the oil companies profited from the Iraqi invasion. What advice would you offer the oil companies?

28. Break-even analysis with multiple products

You are a new consultant with the Boston Group and have been sent to advise the executives of Penury Company. The company recently acquired product line L from an out-of-state concern and now plans to produce it, along with its old standby K, under one roof in a newly renovated facility. Management is quite proud of the acquisition, contending that the larger size and related cost savings will make the company far more profitable. The planned results of a month's operations, based on management's best estimates of the maximum product demanded at today's selling prices are:

| | LINE K | | LINE L | | |
|---------------------|-----------|----------|----------|----------|-----------------|
| | Amount | Per Unit | Amount | Per Unit | Total |
| Sales revenue | \$120,000 | \$1.20 | \$80,000 | \$0.80 | \$200,000 |
| Variable expense | 60,000 | 0.60 | 60,000 | 0.60 | 120,000 |
| Contribution margin | \$60,000 | \$0.60 | \$20,000 | 0.20 | 80,000 |
| Fixed expense | | | | | <u>50,000</u> |
| Net income | | | | | <u>\$30,000</u> |

Required:

- Based on historical operations, K alone incurred fixed expenses of \$40,000, and L alone incurred fixed expenses of \$20,000. Find the break-even point in sales dollars and units for each product separately.
- Give reasons why the fixed costs for the two products combined are expected to be less than the sum of the fixed costs of each product line operating as a separate business.
- Assuming that for each unit of K sold, one unit of L is sold, find the break-even point in sales dollars and units for each product.

29. Average versus Variable Cost

Measer Enterprises produces energy-efficient light bulbs and operates in a highly competitive market in which the bulbs are sold for \$4.50 each. Because of the nature of the production technology, the firm can produce only between 10,000 and 13,000 units per month, in fixed increments of 1,000 units. Measer has the following cost structure:

| Production and Cost Data | | | | |
|--------------------------|-----------------|-----------------|-----------------|-----------------|
| | Units Produced | | | |
| | <u>10,000</u> | <u>11,000</u> | <u>12,000</u> | <u>13,000</u> |
| Factory cost, variable | \$37,000 | \$40,800 | \$44,600 | \$48,400 |
| Factory cost, fixed | 9,000 | 9,000 | 9,000 | 9,000 |
| Selling cost, variable | 6,000 | 6,600 | 7,400 | 8,200 |
| Administration, fixed | 6,000 | 6,000 | 6,000 | 6,000 |
| Total | <u>\$58,000</u> | <u>\$62,400</u> | <u>\$67,000</u> | <u>\$71,600</u> |
| Average unit cost | <u>\$5.80</u> | <u>\$5.67</u> | <u>\$5.58</u> | <u>\$5.51</u> |

Required:

At what output level should the firm operate?

30. Break-even Analysis

The MedView brochure said, "Only 45 scans per month to cover the monthly equipment rental of \$18,000." The footnote at the bottom of the brochure read: "Assumes a reimbursable fee of \$475 per scan."

The MedView brochure refers to a new radiology imaging system that MedView rents for \$18,000 per month. A "scan" refers to one imaging session that is billed at \$475 per scan. Each scan involves giving the patient a chemical injection and requires exposing and developing an X-ray negative.

Required:

- a. What variable cost per scan is MedView assuming in calculating the 45-scans-per-month amount?
- b. Is the MedView brochure really telling the whole financial picture? What is it omitting?

31. Break-even Analysis

Exotic Roses, owned by Margarita Rameriz, provides a variety of rare rose bushes to local nurseries that sell Rameriz's roses to the end consumer (landscapers and retail customers). Rameriz grows the roses from cuttings that she has specifically cultivated for their unusual characteristics (color, size, heartiness, and resistance to disease). Margarita's roses are in great demand as evidenced by the wholesale price she charges nurseries, \$15 per potted plant. Exotic Roses has the following cost structure (variable costs are per potted plant):

| | Fixed Costs per Year | Variable Costs |
|-----------------|----------------------|----------------|
| Plant materials | | \$0.50 |
| Pot | | 0.30 |
| Labor | \$8,000 | 0.70 |
| Utilities | 9,000 | |
| Rent | 7,500 | |
| Other costs | 2,500 | |

Required:

- How many potted rose plants must Exotic Roses sell each year to break even?
- If Rameriz wants to make profits of \$10,000 before taxes per year, how many potted rose plants must be sold?
- If Rameriz wants to make profits of \$10,000 after taxes per year, how many potted rose plants must be sold assuming a 35 percent income tax rate?

32. Break-even Analysis

You are evaluating ways to expand an optometry practice and its earnings capacity. Optometrists perform eye exams, prescribe corrective lenses (eyeglasses and contact lenses), and sell corrective lenses. One way to expand the practice is to hire an additional optometrist. The annual cost of the optometrist, including salary, benefits, and payroll taxes, is \$63,000. You estimate that this individual can conduct two exams per hour at an average price to the patient of \$45 per exam. The new optometrist will work 40-hour weeks for 48 weeks per year. However, because of scheduling conflicts, patient no-shows, training, and other downtime, the new optometrist will not be able to conduct, bill, and collect 100 percent of his or her available examination time.

From past experience, you know that each eye exam drives additional product sales. Each exam will lead to either an eyeglass sale with a net profit (revenue less cost of sales) of \$90 (not including the exam fee) or a contact lens sale with net profits of \$65 (not including the exam fee). On average, 60 percent of the exams lead to eyeglass sales, 20 percent lead to contact lens sales, and 20 percent of the exams lead to no further sales.

Besides the salary of the optometrist, additional costs to support the new optometrist include:

| | |
|------------------------|---------------|
| Office occupancy costs | \$1,200/year |
| Leased equipment | \$330/year |
| Office staff | \$23,000/year |

Required:

In terms of the percentage of available time, what is the minimum level of examinations the new optometrist must perform to recover all the incremental costs of being hired?

Chapter 02 The Nature of Costs **Answer Key**

Multiple Choice Questions

1. Opportunity Costs:

- A. must never be negative
- B. may be found in financial statements (annual report)
- C. reflect the benefit of the next best alternative**
- D. are pecuniary in nature
- E. none of the above

Opportunity costs reflect the benefit of the next best alternative. They may be negative, and may include non-pecuniary elements.

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Measurement

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: 1 Easy

Topic: Characteristics of Opportunity Costs

2. John invested \$12,000 in the stock of Hyper Cyber Eight years later, Hyper Cyber's shares reached \$125,000, but John held onto the shares in the belief that their price would double in the next five years. Unfortunately, Hyper Cyber did not double. Rather the market value of John's shares today is \$4,000. If the shares were sold and the proceeds invested in another investment, they would likely earn 5% per annum. Which of the following terms and values is correct?

- A. \$125,000 is the opportunity cost of selling the shares today
- B.** \$12,000 is a sunk cost
- C. \$250,000 is the opportunity cost
- D. \$2000 is the opportunity cost
- E. None of the above

The original purchase price of the shares is a sunk cost, and cannot be changed by subsequent decisions.

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Examples of Decisions Based on Opportunity Costs

3. Which of the following can be an opportunity cost?

- A. Interest on cost of inventory
- B. Cost of idle capacity
- C. Cost of underutilized labor
- D. The decline in an asset's value
- E.** All of the above

All are examples of opportunity cost.

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making
Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Examples of Decisions Based on Opportunity Costs

4. Davos Inc. makes fiberglass ski-boards in Switzerland. Identify the correct matching of terms.

- A. Fiberglass is factory overhead
- B. Plant real estate taxes are a period cost
- C. Depreciation on delivery trucks is a product cost
- D. Payroll taxes for workers in the Packaging Department are direct labor
- E. None of the above

Payroll taxes for these workers are direct labor. Fiberglass is direct material. Plant real estate taxes are factory overhead. Depreciation on delivery costs is a period cost.

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Measurement

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: 2 Medium

Topic: Direct Costs, Overhead Costs, and Opportunity Costs

Topic: Period versus Product Costs

5. Pamela in Bamplona makes bull-repellent scent according to a traditional Spanish recipe, which normally sells at €9 (Euros) per unit. Normal production volume is 10,000 ounces per month. Average cost is €5 per ounce, of which €2 is direct material and €1 is variable conversion cost. This product is seasonal. After July, demand for this product drops to 6,000 ounces monthly. In November, Umberto offers to buy 1,500 ounces for €6,000.

If Pamela accepts the order, she must design a special label for Umberto at a cost of €500. Each label will cost 25 cents to make and apply. Pamela should:

- A. accept the order, at a gain of €625
- B. reject the order, at a loss of €1,875
- C. reject the order, at a loss of €2,375
- D. accept the order, at a gain of €1,125
- E. none of the above

| | |
|---------------------------------------|--------------|
| Selling price | €4.00 |
| Less: Variable cost | -3.00 |
| Less: Label | <u>-0.25</u> |
| Contribution margin per unit | 0.75 |
| Times Number of units | <u>1500</u> |
| Total Contribution margin | €1,125 |
| - Direct fixed costs (design) | <u>-500</u> |
| Increase in total contribution margin | €625 |

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Copier Example

Topic: Fixed, Marginal, and Average Costs

6. Pamela in Bamplona makes bull-repellent scent according to a traditional Spanish recipe, which normally sells at €9 (Euros) per unit. Normal production volume is 10,000 ounces per month. Average cost is €5 per ounce, of which €2 is direct material and €1 is variable conversion cost. This product is seasonal. After July, demand for this product drops to 6,000 ounces monthly. In November, Umberto offers to buy 1,500 ounces for €6,000.

Now assume that the order is received in July, peak season. If Pamela accepts the order, she will turn away regular customers who order 500 ounces. Pamela should:

- A. reject the order, which loses €1,875
- B. reject the order as it is less than her cost
- C. accept the order if Umberto raises the price higher than €6.58/ounce
- D. accept the order if Umberto raises the price higher than €5.58/ounce
- E. none of the above

Accepting Umberto's order increases total contribution margin by €625. However, turning away regular orders loses total contribution margin of €3,000.

| | | |
|------------------------------|---------------|--------|
| Selling price | €9.00 | |
| - Variable cost | <u>-3.00</u> | normal |
| Contribution margin per unit | €6.00 | |
| Number of units lost | <u>500</u> | ounces |
| Lost contribution margin | <u>€3,000</u> | |

Thus the total order price must be increased to at least cover the net loss of €2,375, (€3,000 - €625). This net loss divided by 1,500 ounces in the order, requires a price increase of at least €1.58 per unit, giving a minimum price of €6.58.

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Copier Example

Topic: Fixed, Marginal, and Average Costs

7. Francois French manufactures cheese, which he normally sells at €20/kg, on which sales commission of 5% is paid. Plant capacity is 7,500 kg/month. Income tax is levied at 30%.

| Fixed costs | | Costs per kg. | |
|--------------------|--------|------------------|----|
| Plant depreciation | €8,000 | Direct materials | €4 |
| Other plant costs | 15,000 | Direct labor | 2 |
| Corporate salaries | 10,000 | Var. factory O/H | 3 |
| Advertising | 3,000 | | |

The number of kilograms to sell to break-even is:

- A. 3,273
- B. 3,600**
- C. 3,000
- D. 2,300
- E. none of the above

Break-even quantity = Total Fixed Costs/Contribution margin per unit

$$= €36,000/€10 = 3,600 \text{ kgs}$$

Contribution margin per unit = Price - (Dir Mat + Dir Lab + Var OH) - Sales commission

$$= €20 - (€4 + €2 + €3) - 5\% \times €20 = €10$$

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Calculating Break-Even and Target Profits

Topic: Copier Example

8. Francois French manufactures cheese, which he normally sells at €20/kg, on which sales commission of 5% is paid. Plant capacity is 7,500 kg/month. Income tax is levied at 30%.

| Fixed costs | | Costs per kg. | |
|--------------------|--------|------------------|----|
| Plant depreciation | €8,000 | Direct materials | €4 |
| Other plant costs | 15,000 | Direct labor | 2 |
| Corporate salaries | 10,000 | Var. factory O/H | 3 |
| Advertising | 3,000 | | |

If sales are 5,000 kgs, which of the following is true?

- A. Total contribution margin is €50,000
- B. Ratio of total contribution margin to net income before taxes is 3.57
- C. Taxes payable are €4,200
- D. Operating leverage is 42%
- E. All of the above

| | |
|---|----------------|
| Total contribution margin (€10 CM × 5,000 kgs) | €50,000 |
| - Total fixed cost | <u>-36,000</u> |
| Net income before tax | €14,000 |
| - Tax @ 30% | <u>-4,200</u> |
| Net income after tax | <u>€9,800</u> |

Ratio of total contribution margin to net income before taxes = €50,000/€14,000 = 3.57

Operating leverage = Total fixed cost/Total cost = €36,000/[5,000 kgs × €10 + €36,000] = 42%.

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Copier Example

9. Francois French manufactures cheese, which he normally sells at €20/kg, on which sales commission of 5% is paid. Plant capacity is 7,500 kg/month. Income tax is levied at 30%.

| Fixed costs | | Costs per kg. | |
|--------------------|--------|------------------|----|
| Plant depreciation | €8,000 | Direct materials | €4 |
| Other plant costs | 15,000 | Direct labor | 2 |
| Corporate salaries | 10,000 | Var. factory O/H | 3 |
| Advertising | 3,000 | | |

Francois French wants to increase after-tax profits to €35,000. Assuming sufficient demand, which strategy achieves this goal?

- A. Sell 7,100 kgs at the present price
- B. Pay the dairy €1/kg less and sell 7,500 kgs
- C. Sell 8,000 kgs at €20.79/kg
- D. Sell 7,500 kgs at the present price and eliminate the sales commission
- E. None of the above

While choice c meets the profit target, it exceeds plant capacity. To generate an after tax profit of €35,000 require a before-tax profit of €50,000 ($€35,000 / .7$). So to cover the fixed costs of €36,000 and the after-tax profits of €50,000, the total contribution margin must be €86,000. If the price were set at 20.79 (and assuming you can sell 8,000 kgs at this price) then $€20.79 - (€4 + €2 + €3) - €1.04 = €10.75 \times 8,000 = €86,000$.

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 2 Medium

Topic: Calculating Break-Even and Target Profits

10. The Mojave Water Agency (MWA) sets water policy and water rates for a desert area that faces a severe water shortage. It has 200,000 customers who are charged \$100 per month for the first 20,000 cubic feet (cu.ft) and 1 cent per cu.ft thereafter. The average customer bill is \$200 per month. It costs the agency $\frac{1}{4}$ cent per cu.ft to monitor and bill for usage. The MWA wants to cut costs by replacing metered billing with a flat fee which would be added to each property owner's real estate tax bill. Which is true?
- A. The proposed policy will be more expensive to operate and will lead to decreased water usage
 - B. The proposed policy will be cheaper to operate and will lead to increased water usage**
 - C. The proposed policy will be cheaper to operate and will lead to decreased water usage
 - D. The most that the MWA should pay the County Real Estate Department for handling the proposed billing process is \$6,000,000
 - E. b) and d) above

The cost of operating the metering, billing and collecting system would be reduced to the fee charged by the County Real Estate Department. For the customer, the bill will be the same regardless of usage, thus usage will increase. It costs the MWA \$75 per customer per month to monitor and bill. The most it should pay is the sum that makes it indifferent between doing the billing itself and assigning those responsibilities to the County.

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Analyze

Difficulty: 3 Hard

Topic: Fixed, Marginal, and Average Costs

11. Hardley sells mamburgers. He faces fixed costs of \$18,000 per month and variable production and marketing costs of \$2 per mamburger. Market research has developed the following demand schedule. Which price/volume combination should Yardley choose?

- A. Price: \$12; Quantity: 4,000
- B. Price: \$10; Quantity: 5,500**
- C. Price: \$8; Quantity: 7,000
- D. Price: \$6; Quantity: 9,000
- E. Unable to determine

| Price | Qty | CM/unit | TCM |
|-------|-------|---------|----------|
| 12 | 4,000 | 10 | \$40,000 |
| 10 | 5,500 | 8 | \$44,000 |
| 8 | 7,000 | 6 | \$42,000 |
| 6 | 9,000 | 4 | \$36,000 |

Yardley should choose the price/volume combination that maximizes total contribution margin (TCM). Selling 5,500 mamburgers at \$10, with CM of \$8, yields TCM of \$44,000.

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: 3 Hard

Topic: Copier Example

12. Bertie's Burritos, a fast food enterprise, wants to understand his cost structure. He collected data, which appears below, to analyze costs using the high-low method.

| Month | Volume | Total costs |
|----------|--------|-------------|
| January | 5,000 | \$2,700 |
| February | 7,000 | \$3,700 |
| March | 6,000 | \$3,400 |

Which is true?

- A. Estimated variable costs are 70 cents per burrito
- B. Fixed costs cannot be estimated
- C. Estimated fixed costs are \$200**
- D. Total costs at volume of 8,000 are estimated at \$4,200
- E. c) and d) only

Using the high-low method, going from 5,000 burritos to 7,000 burritos increases total cost by \$1,000. So, each of these additional 2,000 burritos cost \$1,000. Hence, each of these burritos have an average variable cost of \$0.50. We can plug in the variable cost of \$0.50 per burrito into one of the cost functions and solve for fixed cost (FC):

While it is arithmetically true that total costs at volume of 8,000 are estimated at \$4,200, 8,000 lies outside the relevant range, defined by the range of data collected. Cost behavior outside the relevant range has not been studied.

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Decision Making

Accessibility: Keyboard Navigation

Blooms: Apply

Blooms: Understand

Difficulty: 3 Hard

Topic: Fixed, Marginal, and Average Costs

Topic: Linear Approximations

Essay Questions

13. Fixed, Variable, and Average Costs

Midstate University is trying to decide whether to allow 100 more students into the university. Tuition is \$5,000 per year. The controller has determined the following schedule of costs to educate students:

| Number of Students | Total Costs |
|--------------------|--------------|
| 4,000 | \$30,000,000 |
| 4,100 | 30,300,000 |
| 4,200 | 30,600,000 |
| 4,300 | 30,900,000 |

The current enrollment is 4,200 students. The president of the university has calculated the cost per student in the following manner: $\$30,600,000 / 4,200 \text{ students} = \7286 per student. The president was wondering why the university should accept more students if the tuition is only \$5,000.

Required:

- What is wrong with the president's calculation?
 - What are the fixed and variable costs of operating the university?
-
- The president of the university has calculated the average cost of each student. If the decision is to add more students, the president should be looking at the marginal cost of another student. The marginal cost can be approximated by the variable cost as long as the university is below capacity.
 - The cost of adding 100 students is \$300,000. Therefore, the variable cost per unit is $\$300,000 / 100$, or \$3,000/student.

AACSB: Analytical Thinking

AACSB: Communication

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Blooms: Understand

Difficulty: 3 Hard

Topic: Fixed, Marginal, and Average Costs

14. The Elements of Cost Volume Profit

The M Company's variable costs are 75% of the sales price per unit and their fixed costs are \$240,000. If the company earned \$60,000 before taxes in selling 150,000 units, what was the sales price per unit?

Variable cost per unit = 75% price per unit

Or, $V = .75 P$

Before-tax profit = Total contribution margin less Fixed costs

$\$60,000 = 150,000 \times (P - V) - FC$

$\$60,000 = 150,000 \times (P - .75P) - \$240,000$

$\$300,000 = 150,000 \times .25P$

$\$300,000 = 37,500 P$

$P = \$8.00$

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Measurement

Blooms: Apply

Difficulty: 3 Hard

Topic: Linear Approximations

15. Opportunity Costs

The First Church has been asked to operate a homeless shelter in part of the church. To operate a homeless shelter the church must hire a full time employee for \$1,200/month to manage the shelter. In addition, the church would have to purchase \$400 of supplies/month for the people using the shelter. The space that would be used by the shelter is rented for wedding parties. The church averages about 5 wedding parties a month that pay rent of \$200 per party. Utilities are normally \$1,000 per month. With the homeless shelter, the utilities will increase to \$1,300 per month.

What is the opportunity cost to the church of operating a homeless shelter in the church?

The monthly opportunity cost of operating a homeless shelter is:

| | |
|---|----------------|
| Full-time employee | \$1,200 |
| Supplies | 400 |
| Use of space (forgone revenue: 5 parties × \$200/party) | 1,000 |
| Increase in utilities \$1,300 - \$1,000 | <u>300</u> |
| Total | <u>\$2,900</u> |

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Measurement

Blooms: Apply

Difficulty: 3 Hard

Topic: Characteristics of Opportunity Costs

Topic: Opportunity Costs

16. Fixed and Variable Costs:

The university athletic department has been asked to host a professional basketball game at the campus sports center. The athletic director must estimate the opportunity cost of holding the event at the sports center. The only other event scheduled for the sports center that evening is a fencing match that would not have generated any additional costs or revenues. The fencing match can be held at the local high school, but the rental cost of the high school gym would be \$200. The athletic director estimates that the professional basketball game will require 20 hours of labor to prepare the building. Clean-up depends on the number of spectators. The athletic director estimates the time of clean-up to be 2 minutes per spectator. The labor would be hired especially for the basketball game and would cost \$16 per hour. Utilities will be \$500 greater if the basketball game is held at the sports center. All other costs would be covered by the professional basketball team.

Required:

- a. What is the variable cost of having one more spectator?
- b. What is the opportunity cost of allowing the professional basketball team to use the sports center if 10,000 spectators are expected?
- c. What is the opportunity cost of allowing the professional basketball team to use the sports center if 12,000 spectators are expected?

- a. The variable cost of one more spectator is the cost of clean-up:

$$(2 \text{ minutes}/60 \text{ minutes/hour})(\$16/\text{hour}) = \$0.5333$$

- b. The opportunity cost with 10,000 spectators is:

| | |
|--|----------------|
| Cost of relocating the fencing match | \$200 |
| Cost of labor for preparation (20 hours)(\\$16/hour) | 320 |
| Cost of additional utilities | 500 |
| Cost of clean-up (10,000)(\\$0.53333) | <u>5,333</u> |
| Total | <u>\$6,353</u> |

c. The opportunity cost with 12,000 spectators is:

| | |
|---|----------------|
| Cost of relocating the fencing match | \$200 |
| Cost of labor for preparation (20 hours)(\$16/hour) | 320 |
| Cost of additional utilities | 500 |
| Cost of clean-up (12,000)(\$0.53333) | <u>6,400</u> |
| Total | <u>\$7,420</u> |

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Measurement

Blooms: Apply

Difficulty: 3 Hard

Topic: Characteristics of Opportunity Costs

Topic: Fixed, Marginal, and Average Costs

Topic: Opportunity Costs

17. Opportunity Cost of Attracting Industry

The Itagi Computer Company from Japan is looking to build a factory for making Wi-Fi routers in the United States. The company is concerned about the safety and well-being of its employees and wants to locate in a community with good schools. The company also wants the factory to be profitable and is looking for subsidies from potential communities.

Encouraging new business to create jobs for citizens is important for communities, especially communities with high unemployment.

Wellville has not been very well since the shoe factory left town. The city officials have been working on a deal with Itagi to get the company to locate in Wellville. Itagi officials have identified a 20 acre undeveloped site. The city has tentatively agreed to buy the site for \$50,000 for Itagi and not require any payment of property taxes on the factory by Itagi for the first five years of operation. The property tax deal will save Itagi \$3,000,000 in taxes over the five years. This deal was leaked to the local newspaper. The headlines the next day were: "Wellville Gives Away \$3,000,000 + to Japanese Company".

Required:

- a. Do the headlines accurately describe the deal with Itagi?
- b. What are the relevant costs and benefits to the citizens of Wellville of making this deal?

a. The headlines are not an accurate portrayal of the deal with Itagi. The analysis should consider the alternative of not having Itagi come to town. Compared to the alternative, Wellville is only paying \$50,000 to buy the land and losing the property taxes on 20 acres of undeveloped land, which is probably quite small.

b. The opportunity benefits to the town of Wellville include increased jobs and increased property taxes after the first five years. The opportunity costs include increased congestion and the cost of increased city services. The problems associated with becoming a larger community should also be considered.

AACSB: Communication

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Understand

Difficulty: 2 Medium

Topic: Characteristics of Opportunity Costs

Topic: Fixed, Marginal, and Average Costs

Topic: Opportunity Costs

18. Cost, Volume, Profit Analysis

With the possibility of the US Congress relaxing timber cutting restrictions, a local lumber company is considering an expansion of its facilities. The company believes it can sell lumber for \$0.18/board foot. A board foot is a measure of lumber. The tax rate for the company is 30 percent. The company has the following two opportunities:

- Build Factory A with annual fixed costs of \$20 million and variable costs of \$0.10/board foot. This factory has an annual capacity of 500 million board feet.
- Build Factory B with annual fixed costs of \$10 million and variable costs of \$0.12/board foot. This factory has an annual capacity of 300 million board feet.

Required:

- a. What is the break-even point in board feet for Factory A?
- b. If the company wants to generate an after tax profit of \$2 million with Factory B, how many board feet would the company have to process and sell?
- c. If demand for lumber is uncertain, which factory is riskier?
- d. At what level of board feet would the after-tax profit of the two factories be the same?

a. Break-even point of Factory A = $\$20,000,000 / (\$0.18 - \$0.10) = 250,000,000$ board-feet

b. To achieve an after-tax profit of \$2,000,000:

$$[\$10,000,000 + (\$2,000,000 / (1 - .3))] / (\$0.18 - \$0.12) = 14,285,717 \text{ board-feet}$$

c. Factory A has higher fixed costs, but lower variable costs per unit because of its larger capacity. If the demand for lumber is lower than expected, Factory A will have a more difficult time recovering its fixed costs. The break-even point for factory B is lower than the break-even point for factory A. Therefore, Factory A is the riskier investment.

d. The after-tax profits of the two factories will be the same when:

$$\begin{aligned} & (1 - .3)[(\$0.18 - \$0.10)(\text{Quantity}) - \$20,000,000] \\ & = (1 - .3)[(\$0.18 - \$0.12)(\text{Quantity}) - \$10,000,000] \end{aligned}$$

$$\text{Quantity} = 500 \text{ million board feet}$$

AACSB: Analytical Thinking

AACSB: Communication
AACSB: Knowledge Application
AICPA: BB Industry
AICPA: FN Decision Making
AICPA: FN Risk Analysis
Blooms: Apply
Difficulty: 3 Hard
Topic: Calculating Break-Even and Target Profits

19. Cost, Volume, Profit Analysis

Leslie Mittelberg is considering the wholesaling of a leather handbag from Kenya. She must travel to Kenya to check on quality and transportation. The trip will cost \$3,000. The cost of the handbag is \$10 and shipping to the United States can occur through the postal system for \$2 per handbag or through a freight company which will ship a container that can hold up to a 1,000 handbags at a cost of \$1,000. The freight company will charge \$1,000 even if less than 1,000 handbags are shipped. Leslie will try to sell the handbags to retailers for \$20. Assume there are no other costs and benefits.

Required:

- a. What is the break-even point shipping through the postal system?
- b. How many units must be sold if Leslie uses the freight company and she wants to have a profit of \$1,000?
- c. At what output level would the two shipping methods yield the same profit?
- d. Suppose a large discount store asks to buy an additional 1,000 handbags beyond normal sales. Which shipping method should be used and what is the minimum sales price Leslie should consider in selling those 1,000 handbags?

a. Through the postal system, the variable cost per unit is \$10 + \$2 or \$12. Therefore, the break-even point is:

$$\$3,000/(\$20 - \$12) = 375 \text{ handbags}$$

b. The fixed costs through the freight company are \$3,000 + \$1,000 or \$4,000 if fewer than 1,000 bags are purchased. The only variable cost is the \$10 purchase cost. To make a profit of \$1,000, Leslie must buy and sell:

$$(\$4,000 + \$1,000)/(\$20 - \$10) = 500 \text{ handbags}$$

c. The two methods would yield the same profit for the following quantity of handbags:

$$(\$20 - \$12)(\text{Quantity}) - \$3,000 = (\$20 - \$10)(\text{Quantity}) - \$4,000$$

$$\text{Quantity} = 500 \text{ handbags}$$

d. The 1,000 handbags will be most cheaply transported by container. Leslie's trip expenses of \$3,000 will occur anyway, so they are not relevant for pricing the special order. The

incremental cost of the additional 1,000 handbags is the cost of the container (\$1,000) and the purchase cost of the handbags (\$10/handbag)(1,000 handbags) or a total of \$11,000. If the special order has no other effect on long term sales, then Leslie should accept a sales price above the \$11,000 incremental cost, or above \$11 per bag.

AACSB: Analytical Thinking

AACSB: Communication

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

20. Multiple Product Cost Volume Profit

A company sells three products as shown below:

| | Product X | Product Y | Product Z | Total |
|------------------------|--------------|--------------|--------------|-----------|
| Units | 60,000 | 140,000 | 50,000 | 250,000 |
| Sales | \$90,000 | \$150,000 | \$60,000 | \$300,000 |
| Variable Costs | \$63,000 | \$93,000 | \$19,000 | \$175,000 |
| Contribution Margin | | | | \$125,000 |
| Fixed Costs | | | | \$100,000 |

These three products all always sold in fixed proportions. In other words, Product X always accounts for 24% of total sales (60,000/250,000), Product Y always accounts for 56% of total sales (140,000/250,000), and Product Z always accounts for 20% of total sales (50,000/250,000).

Required:

- How many units of each product need to be sold to break-even?
- How many units must of each product must be sold if the company wants to have a profit of \$50,000?

$$a. \text{Weighted Contribution Margin per Unit} = \$125,000/250,000 = \$0.50$$

$$\$100,000 \text{ fixed costs}/\$0.50 \text{ weighted Contribution Margin per unit}$$

$$= 200,000 \text{ units in total to break-even}$$

$$X = 60,000/250,000 = 24\% \text{ of total units sold}$$

$$.24 \times 200,000 = 48,000 \text{ units}$$

$$Y = 140,000/250,000 = 56\% \text{ of total units sold}$$

$$.56 \times 200,000 = 112,000 \text{ units}$$

$$Z = 50,000/250,000 = 20\% \text{ of total units sold}$$

$$.20 \times 200,000 = 40,000 \text{ units}$$

$$\text{b. Weighted Contribution Margin per Unit} = \$125,000/250,000 = \$0.50$$

$$(\$100,000 \text{ fixed costs} + \$50,000 \text{ target profit})/\$0.50 \text{ weighted Contribution Margin per unit}$$

$$= 300,000 \text{ units in total to earn } \$50,000$$

$$X = 60,000/250,000 = 24\% \text{ of total units sold}$$

$$.24 \times 300,000 = 72,000 \text{ units}$$

$$Y = 140,000/250,000 = 56\% \text{ of total units sold}$$

$$.56 \times 300,000 = 168,000 \text{ units}$$

$$Z = 50,000/250,000 = 20\% \text{ of total units sold}$$

$$.20 \times 200,000 = 40,000 \text{ units}$$

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Measurement

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

Topic: Copier Example

Topic: Multiple Products

21. Make or Buy

A company needs 10,000 units of a component used in producing one of its products. The latest internal accounting reports show that the per unit manufacturing cost to be \$150.00, variable manufacturing costs of \$110.00 and fixed manufacturing cost of \$40. The company recently received an offer from another manufacturer to produce the component for \$144.00. If it buys the component on the outside 40% of the fixed manufacturing cost can be avoided.

Required:

- a. If the company buys the component from the outside supplier at \$144.00, what is the impact on income?
- b. What price would make the company indifferent between making the component internally and having the outside supplier make it?

a. \$18,000 (\$18.00 per unit more costly to buy on the outside × 10,000 units)

| | Make | Buy |
|----------------------------------|-----------------|-----------------|
| Variable Manufacturing Costs | \$110.00 | \$0.00 |
| Fixed Manufacturing Cost avoided | \$0.00 | (\$16.00) |
| Purchase Price | <u>\$0.00</u> | <u>\$144.00</u> |
| Total | <u>\$110.00</u> | <u>\$128.00</u> |

b. \$126.00

| | Make | Buy |
|----------------------------------|-----------------|-----------------|
| Variable Manufacturing Costs | \$110.00 | \$0.00 |
| Fixed Manufacturing Cost avoided | \$0.00 | (\$16.00) |
| Purchase Price | <u>\$0.00</u> | <u>\$126.00</u> |
| Total | <u>\$110.00</u> | <u>\$110.00</u> |

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Measurement

Blooms: Apply

Difficulty: 3 Hard

Topic: Linear Approximations

22. Cost, Volume, Profit Analysis

Easy Go Company manufactures a line of electric garden tools that are sold in general hardware stores. The company's controller, Amy Tait, has just received the sales forecast for the coming year for Easy Go's three products: weeders, hedge clippers, and leaf blowers. Easy Go has experienced considerable variations in sales volumes and variable costs over the past two years, and Harlow believes the forecast should be carefully evaluated from a cost-volume-profit viewpoint. The preliminary budget information for the next year is presented below.

| | Weeders | Hedge Clippers | Leaf Blowers |
|--|---------|-------------------|-----------------|
| Unit sales | 50,000 | 50,000 | 100,000 |
| Unit selling price | \$28.00 | \$36.00 | \$48.00 |
| Variable manufacturing cost per unit | 13.00 | 12.00 | 25.00 |
| Variable selling cost per unit | 5.00 | 4.00 | 6.00 |

For the next year, Easy Go's fixed factory overhead is budgeted at \$2 million, and the company's fixed selling and administrative expenses are forecast to be \$600,000. Easy Go has a tax rate of 40 percent.

Required:

- Determine Easy Go Co.'s budgeted net income for next year.
- Assuming that the sales mix remains as budgeted, determine how many units of each product Easy Go must sell in order to break even next year.
- Determine the total dollar sales Easy Go must sell next year in order to earn an after-tax net income of \$450,000.
- After preparing the original estimates, Easy Go determines that its variable manufacturing cost of leaf blowers will increase 20 percent and the variable selling cost of hedge clippers can be expected to increase \$1 per unit. However, Easy Go has decided not to change the selling price of either product. In addition, Easy Go learns that its leaf blower is perceived as the best value on the market, and it can expect to sell three times as many leaf blowers as any other product. Under these circumstances, determine how many units of each product Easy Go will have to sell to break even in next year.

e. Explain the limitations of cost-volume-profit analysis that Amy Tait should consider when evaluating Easy Go's next year's budget.

a. Easy Go Co.'s budgeted net income for next year

| Easy Go Company Budgeted Net Income for Next Year | | | | |
|--|------------------|--------------------|--------------------|--------------------|
| | Weeders | Hedge Clippers | Leaf Blowers | Total |
| Unit selling price | <u>\$28.00</u> | <u>\$36.00</u> | <u>\$48.00</u> | |
| Variable manufacturing cost | \$13.00 | \$12.00 | \$25.00 | |
| Variable selling cost | <u>5.00</u> | <u>4.00</u> | <u>6.00</u> | |
| Total variable costs | <u>\$18.00</u> | <u>\$16.00</u> | <u>\$31.00</u> | |
| Contribution margin | \$10.00 | \$20.00 | \$17.00 | |
| Unit sales | <u>50,000</u> | <u>50,000</u> | <u>100,000</u> | |
| Total Contribution | <u>\$500,000</u> | <u>\$1,000,000</u> | <u>\$1,700,000</u> | <u>\$3,200,000</u> |

| | |
|--|------------------|
| Fixed factory overhead | 2,000,000 |
| Fixed selling and administrative expense | <u>600,000</u> |
| Total fixed costs | <u>2,600,000</u> |
| Income before taxes | 600,000 |
| Income taxes @ 40% | <u>240,000</u> |
| Budgeted net income | <u>\$360,000</u> |

b. The number units of each product Easy Go must sell in order to break even next year:

| | Unit Contribution | Sales Proportion | Proportional Contribution |
|--|----------------------|---------------------|------------------------------|
| Weeders | \$10.00 | .25 | \$2.50 |
| Hedge Clippers | 20.00 | .25 | 5.00 |
| Leaf Blowers | 17.00 | .50 | <u>8.50</u> |
| Proportional contribution margin/bundle | | | <u>\$16.00</u> |

| | | |
|--------------------------------|---|--|
| Total unit sales to break-even | = | <u>Total fixed costs</u> Proportional contribution |
| | = | <u>\$2,600,000</u> \$16 |
| | = | <u>162,500 units</u> |

| | Sales Proportion | Total Unit Sales | Product Line Sales |
|-------------------|---------------------|---------------------|-----------------------|
| Weeders | .25 | 162,500 | 40,625 |
| Hedge Clippers | .25 | 162,500 | 40,625 |
| Leaf Blowers | .50 | 162,500 | 81,250 |

c. Total dollar Easy Go must sell next year in order to earn an after-tax net income of \$450,000

| | Selling Price | Sales Proportion | Proportional Selling Price |
|----------------------------|------------------|---------------------|----------------------------------|
| Weeders | \$28.00 | .25 | \$ 7.00 |
| Hedge Clippers | 36.00 | .25 | 9.00 |
| Leaf Blowers | 48.00 | .50 | <u>24.00</u> |
| Proportional selling price | | | <u>\$40.00</u> |

| | | |
|--------------------------|---|--|
| Contribution margin rate | = | $\frac{\text{Proportional contribution}}{\text{Proportional selling price}}$ |
| | = | $\frac{\$16}{\$40}$ |
| | = | <u>40 percent</u> |

| | | |
|--------------------|---|---|
| Total dollar sales | = | $\frac{\text{Fixed costs} + \text{After-tax income} \div (1 - \text{tax rate})}{\text{Contribution margin rate}}$ |
| | = | $\frac{\$2,600,000 + \$450,000}{.4}$ |
| | = | $\frac{\$3,350,000}{.4}$ |
| | = | <u>\$8,375,000</u> |

d. The Number of units of each product Easy Go will have to sell to break even in next year:

| | Unit Contribution | Sales Proportion | Proportional Contribution |
|--|-------------------|------------------|---------------------------|
| Weeders | \$10.00 | .20 | \$2.00 |
| Hedge Clippers ¹ | 19.00 | .20 | 3.80 |
| Leaf Blowers ² | 12.00 | .60 | <u>7.20</u> |
| Total proportional contribution margin | | | <u>\$13.00</u> |

| | | |
|--------------------------------|---|---|
| Total unit sales to break-even | = | $\frac{\text{Total fixed costs}}{\text{Proportional contribution}}$ |
|--------------------------------|---|---|

| | | |
|--|---|----------------------------|
| | = | <u>\$2,600,000</u> \$13 |
| | = | <u>200,000 units</u> |

| | Sales Proportion | Total Unit Sales | Product Line Sales |
|-------------------|-----------------------------|-----------------------------|-------------------------------|
| Weeders | .20 | 200,000 | 40,000 |
| Hedge Clippers | .20 | 200,000 | 40,000 |
| Leaf Blowers | .60 | 200,000 | 120,000 |

¹ Variable selling costs increase; thus the unit contribution decreases to \$19 [$\$36 - (\$12 + 4 + 1)$].

² The variable manufacturing cost increase 20 percent; thus, the unit contribution decreases to \$12 [$\$48 - (1.2 \times 25) - 6$].

e. Amy Tait should consider the following limitations when using cost-volume-profit analysis to evaluate Easy Go Company's budget. This type of analysis assumes that:

- all costs are either fixed or variable or can be broken down into fixed and variable components.
- all costs are linear in the relevant range, i.e., variable costs change in total with a change in activity and fixed costs remain the same at all levels of output and sales in the relevant range.
- sales prices will not change and sales demand is unlimited at the unit selling prices.

AACSB: Communication

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

Topic: Copier Example

Topic: Limitations of Cost-Volume-Profit Analysis

Topic: Multiple Products

23. Break-even and Cost-Volume-Profit with Taxes

DisKing Company sells used DVDs on line. The projected after-tax net income for the current year is \$120,000 based on a sales volume of 200,000 DVDs. DisKing has been selling the disks at \$16 each. The variable costs consist of the \$10 unit purchase price of the disks and a handling cost of \$2 per disk. DisKing's annual fixed costs are \$600,000 and DisKing is subject to a 40 percent income tax rate.

Required:

- Calculate DisKing Company's break-even point for the current year in number of DVDs.
- Calculate the increased after-tax income for the current year if projected unit sales volume increase 10 percent.
- Management expects that the price DisKing pays for used DVDs to increase 30 percent next year. If the unit selling price remains at \$16, calculate the volume of sales in dollars that DisKing Company must achieve in the coming year to maintain the same after-tax net income as projected for the current year.

a.

| | | | | |
|------------|---|-------------------------------|---|---------------|
| Break-even | = | $\frac{\$600,000}{\$16 - 12}$ | = | 150,000 units |
|------------|---|-------------------------------|---|---------------|

b.

| | |
|---|------------------|
| Sales $200,000 \times 16 \times 1.1$ | \$3,520,000 |
| Variable Costs $200,000 \times 12 \times 1.1$ | (2,640,000) |
| Fixed Costs | <u>(600,000)</u> |
| Net income before tax | 280,000 |
| Taxes (40%) | <u>(112,000)</u> |
| Net income after taxes | 168,000 |
| Net income @ 200,000 units | 120,000 |
| Increase in net income | <u>\$48,000</u> |

c. Let Q = unit sales. Then,

| | |
|--|---|
| $(16Q - 1.3 \times 10Q - 2Q - 600,000) (60\%)$ | = 120,000 |
| $Q - 600,000$ | = 200,000 |
| Q | = 800,000 |
| PQ | = $\$16 \times 800,000 =$ \$12,800,000 |

AACSB: Analytical Thinking

AACSB: Communication

AACSB: Ethics

AACSB: Knowledge Application

AACSB: Reflective Thinking

AACSB: Technology

AICPA: BB Critical Thinking

AICPA: BB Global

AICPA: BB Industry

AICPA: BB Legal

AICPA: BB Leveraging Technology

AICPA: BB Marketing

AICPA: BB Resource Management

AICPA: FN Decision Making

AICPA: FN Leveraging Technology

AICPA: FN Measurement

AICPA: FN Reporting

AICPA: FN Risk Analysis

Blooms: Analyze

Blooms: Apply

Blooms: Create

Blooms: Evaluate

Blooms: Remember

Blooms: Understand

Difficulty: 1 Easy

Difficulty: 2 Medium

Difficulty: 3 Hard

Topic: Account Classification

Topic: Activity Measures

Topic: Calculating Break-Even and Target Profits

Topic: Characteristics of Opportunity Costs

Topic: Copier Example

Topic: Direct Costs, Overhead Costs, and Opportunity Costs

Topic: Examples of Decisions Based on Opportunity Costs

Topic: Fixed, Marginal, and Average Costs

Topic: Limitations of Cost-Volume-Profit Analysis

Topic: Linear Approximations

Topic: Motion and Time Studies

Topic: Multiple Products

Topic: Operating Leverage

Topic: Opportunity Costs

Topic: Opportunity Costs versus Accounting Costs

Topic: Other Cost Behavior Patterns

Topic: Period versus Product Costs

24. Cost-Volume-Profit of a Make/Buy Decision

Telly Industries is a multiproduct company that currently manufactures 30,000 units of Part MR24 each month. The facilities now being used to produce Part MR24 have a fixed monthly cost of \$150,000 and a capacity to produce 84,000 units per month. If Telly were to buy Part MR24 from an outside supplier, the facilities would be idle, but its fixed costs would continue at 40 percent of its present amount. The variable production costs of Part MR24 are \$11 per unit.

Required:

- a. If Telly Industries continues to use 30,000 units of Part MR24 each month, it would realize a net benefit by purchasing Part MR24 from an outside supplier only if the supplier's unit price is less than how much?
- b. If Telly Industries can obtain Part MR24 from an outside supplier at a unit purchase price of \$12.875, what is the monthly usage at which it will be indifferent between purchasing and making Part MR24?

a. Each month Telly incurs \$150,000 of fixed cost to have capacity to produce 84,000 units. They are only using 30,000 units of that capacity now. If they outsource MR24, they will continue to incur 40% of the fixed costs, or \$60,000. However, they save \$90,000 (\$150,000 - \$60,000). Besides saving the fixed costs they save \$330,000 of variable costs (\$11 × 30,000) or a total cost savings of \$420,000. To be indifferent between outsourcing and continuing to produce, the outside price must be \$14 (\$420,000 ÷ 30,000). An alternative way to solve the problem and get the same answer is:

| | | | | | | |
|------------------|---|---|---|------------------|---|--|
| Outside Price | + | $\frac{40\% \text{ of } \text{Fixed Cost}}{30,000 \text{ Units}}$ | = | Variable cost | + | $\frac{\text{Fixed Cost}}{30,000 \text{ Units}}$ |
|------------------|---|---|---|------------------|---|--|

| | | | | | | | | |
|---|---|------|---|----------------------------|---|--|---|---------|
| P | = | \$11 | + | $\frac{\$150,000}{30,000}$ | - | $\frac{\$150,000 \times 40\%}{30,000}$ | = | \$14,00 |
|---|---|------|---|----------------------------|---|--|---|---------|

b.

| | | | | | | |
|----------|---|--|---|------|---|-------------------------------------|
| \$12.875 | + | $\frac{40\% \text{ of Fixed Cost}}{Q \text{ Units}}$ | = | \$11 | + | $\frac{\$150,000}{Q \text{ Units}}$ |
|----------|---|--|---|------|---|-------------------------------------|

$$\$12.875Q + \$60,000 = \$11Q + \$150,000$$

$$\$1.875Q = \$90,000$$

$$Q = 48,000 \text{ units}$$

AACSB: Analytical Thinking

AACSB: Communication

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AACSB: Reflective Thinking

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AICPA: BB Critical Thinking

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Blooms: Analyze

Blooms: Apply

Blooms: Create

Blooms: Evaluate

Blooms: Remember

Blooms: Understand

Difficulty: 1 Easy

Difficulty: 2 Medium

Difficulty: 3 Hard

Topic: Account Classification

Topic: Activity Measures

Topic: Calculating Break-Even and Target Profits

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Topic: Other Cost Behavior Patterns
Topic: Period versus Product Costs

25. Opportunity Cost of Purchase Discounts and Lost Sales

Spring Company manufactures hard drives for computer manufacturers. At the beginning of this year Spring began shipping a much-improved hard drive, Model W899. The W899 was an immediate success and accounted for \$5 million in revenues for Spring this year.

While the W899 was in the development stage, Spring planned to price it at \$130. In preliminary discussions with customers about the W899 design, no resistance was detected to suggestions that the price might be \$130. The \$130 price was considerably higher than the estimated variable cost of \$70 per unit to produce the W899, and it would provide Spring with ample profits.

Shortly before setting the price of the W899, Spring discovered that a competitor had a product very similar to the W899 and was no more than 60 days behind Spring's own schedule. No information could be obtained on the competitor's planned price, although it had a reputation for aggressive pricing. Worried about the competitor, and unsure of the market size, Spring lowered the price of the W899 to \$100. It maintained the price although, to Spring's surprise, the competitor announced a price of \$130 for its product.

After reviewing the current year's sales of the W899, Spring's management concluded that unit sales would have been the same if the product had been marketed at the original price of \$130 each. Management has predicted that next year's sales of the W899 would be either 85,000 units at \$100 each or 60,000 units at \$130 each. Spring has decided to raise the price of the disk drive to \$130 effective immediately.

Having supported the higher price from the beginning, Sharon Haley, Spring's marketing director, believes that the opportunity cost of selling the W899 for \$100 should be reflected in the company's internal records and reports. In support of her recommendation, Haley explained that the company has booked these types of costs on other occasions when purchase discounts not taken for early payment have been recorded.

Required:

- a. Define *opportunity cost* and explain why opportunity costs are not usually recorded.
- b. What is the current year's opportunity cost?
- c. Explain the impact of Spring Company's selection of the \$130 selling price for the W899 on next year's operating income. Support your answer with appropriate calculations.

- a. Opportunity cost is defined as the profit that could have been realized if a particular action was not chosen. Opportunity costs occur because a firm is faced with alternative uses of

resources.

Opportunity costs are not ordinarily incorporated in formal accounting systems because

- they do not involve cash receipts or outlays (absence of a transaction).
- the next best opportunity is often difficult to determine.
- these types of costs often are not readily measurable.

b. Opportunity cost in the current year = Units sold × Opportunity cost per unit

| | | |
|------------------------------|---|--|
| Units sold | = | $\frac{\text{Revenue}}{\text{Unit sale price}}$ |
| | = | $\frac{\$5,000,000}{\$100}$ |
| Revenue per unit | = | 50,000 units sold |
| Variable cost per unit | = | $50,000 \times (\$130 - 100)$ |
| Contribution margin per unit | = | \$1,500,000 opportunity cost in the current year |

c. The selection of the \$130 selling price for the W899 will increase Spring's next year operating income by \$1,050,000. This is equal to the increase in total contribution shown in the analysis of projected sales of the W899 presented below.

| | \$100 Selling Price | \$130 Selling Price |
|------------------------------|----------------------------|----------------------------|
| Revenue per unit | \$100 | \$130 |
| Variable cost per unit | <u>70</u> | <u>70</u> |
| Contribution margin per unit | <u>\$30</u> | <u>\$60</u> |

Total contribution:

| | | |
|---|---|------------------|
| At \$130 selling price 60,000 units × \$60 | = | \$3,600,000 |
| At \$100 selling price 85,000 units × \$30 | = | <u>2,550,000</u> |

| | | |
|--------------------------------|---|-------------|
| Net gain in total contribution | = | \$1,050,000 |
|--------------------------------|---|-------------|

AACSB: Analytical Thinking
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26. Make/Buy and the Opportunity Cost of Freed Capacity

Zelean Manufacturing uses 10 units of part KJ37 each month in the production of radar equipment. The cost to manufacture one unit of KJ37 is presented in the accompanying table.

| | |
|--|-----------------|
| Direct materials | \$1,000 |
| Materials handling (20% of direct material cost) | 200 |
| Direct labor | 8,000 |
| Manufacturing overhead | <u>12,000</u> |
| Total manufacturing cost | <u>\$21,200</u> |

Materials handling represents the direct variable costs of the receiving department and is applied to direct materials and purchased components on the basis of their cost. This is a separate charge in addition to manufacturing overhead. Zelean's annual manufacturing overhead budget is one-third variable and two-third fixed. Scott Supply, one of Zelean's reliable vendors, has offered to supply part KJ37 at a unit price of \$15,000. The fixed cost of producing KJ37 is the cost of a special piece of testing equipment that ensures the quality of each part manufactured. This testing equipment is under a long-term, noncancelable lease. If Zelean were to purchase part KJ37, materials handling costs would not be incurred.

Required:

- If Zelean purchases the KJ37 units from Scott, the capacity Zelean was using to manufacture these parts would be idle. Should Zelean purchase the parts from Scott? Make explicit any key assumptions.
- Assume Zelean Manufacturing is able to rent all idle capacity for \$25,000 per month. Should Zelean purchase from Scott Supply? Make explicit any key assumptions.
- Assume that Zelean Manufacturing does not wish to commit to a rental agreement but could use idle capacity to manufacture another product that would contribute \$52,000 per month. Should Zelean manufacture KJ37? Make explicit any key assumptions.

- Cost of outside purchase:

| | |
|------------------|----------|
| Payment to Scott | \$15,000 |
|------------------|----------|

| | |
|--|----------------|
| Continuing cost of idle capacity (12,000 × 2/3) | <u>8,000</u> |
| | \$23,000 |
| Cost if continue to make: | <u>21,200</u> |
| Incremental cost of purchase | <u>\$1,800</u> |

Explicit assumption: the two-thirds of the fixed manufacturing overhead (\$8,000) is not a sunk cost and will still be incurred if the facility is idle.

b. Cost of outside purchase:

| | |
|--------------------------------------|----------------|
| Payment to Scott | \$15,000 |
| Continuing cost of capacity | 8,000 |
| Lease receipts (\$25,000 ÷ 10 units) | <u>(2,500)</u> |
| Net cash outlay of purchase | 20,500 |
| Cost if continue to make | <u>21,200</u> |
| Incremental cost of making | <u>\$700</u> |

Explicit assumption: the two-thirds of the fixed manufacturing overhead (\$8,000) is not a sunk cost and will still be incurred if the facility is idle.

c. Cost of outside purchase:

| | |
|---|----------------|
| Payment to Scott | \$15,000 |
| Continuing cost of capacity | 8,000 |
| Contribution from new product (\$52,000 ÷ 10 units) | <u>(5,200)</u> |
| Net cash outlay of purchase | \$17,800 |
| Cost if continue to make | <u>21,200</u> |
| Incremental cost of manufacturing | <u>\$3,400</u> |

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Measurement

Blooms: Apply

Difficulty: 3 Hard

Topic: Characteristics of Opportunity Costs

Topic: Examples of Decisions Based on Opportunity Costs

27. "Price gouging" or increased opportunity cost?

After the Iraqi invasion of Kuwait in August 1990, the world price of crude oil doubled to more than \$30 per barrel in anticipation of reduced supply. Immediately, the oil companies raised the retail price on refined oil products even though these products were produced from oil purchased at the earlier, lower prices. The media charged the oil companies with profiteering and price gouging, and politicians promised immediate investigations.

Required:

Critically evaluate the charge that the oil companies profited from the Iraqi invasion. What advice would you offer the oil companies?

The opportunity cost of the oil in process was higher after the invasion and thus the oil companies were justified in raising prices as quickly as they did. For example, suppose the oil company had one barrel of oil purchased at \$15. This barrel was refined and processed for another \$5 of cost and then the refined products from the barrel sold for \$21. Replacing that barrel requires the oil company to pay another \$15 per barrel on top of the \$15 per barrel it is already paying. Therefore, in order to replace the old barrel, the prices of the refined products must be raised as soon as the crude oil price rises.

However, accounting treats the realized holding gain on the old oil as an accounting profit, not as an opportunity cost. Therefore, the income statement of oil companies with large stocks of in-process crude will show accounting profits, unless they can somehow defer these profits. Switching to income-decreasing accounting methods and writing off obsolete equipment will help the oil companies avoid the political embarrassment of reporting the holding gains. In January 1990, the large oil companies received significant adverse media publicity when they reported large increases in fourth-quarter profits.

It is useful having discussed this problem to ask the following question: What happens to oil companies in the reverse situation when a large, unexpected price drop occurs? Suppose the oil company purchased old barrels for \$15 and sold the refined products for \$21. New barrels now can be purchased for \$10. The company would like to keep selling refined products at \$21, but competition from other oil companies will push the price of refined products down. Depending on how quickly the price of refined products fall, the oil companies will report smaller (maybe even negative) accounting earnings as their inventory of \$15 oil gets refined and sold, but at lower prices.

AACSB: Analytical Thinking
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AICPA: BB Industry
AICPA: FN Decision Making
Blooms: Analyze
Difficulty: 3 Hard
Topic: Characteristics of Opportunity Costs
Topic: Examples of Decisions Based on Opportunity Costs
Topic: Opportunity Costs

28. Break-even analysis with multiple products

You are a new consultant with the Boston Group and have been sent to advise the executives of Penury Company. The company recently acquired product line L from an out-of-state concern and now plans to produce it, along with its old standby K, under one roof in a newly renovated facility. Management is quite proud of the acquisition, contending that the larger size and related cost savings will make the company far more profitable. The planned results of a month's operations, based on management's best estimates of the maximum product demanded at today's selling prices are:

| | LINE K | | LINE L | | |
|---------------------|-----------|----------|----------|----------|-----------------|
| | Amount | Per Unit | Amount | Per Unit | Total |
| Sales revenue | \$120,000 | \$1.20 | \$80,000 | \$0.80 | \$200,000 |
| Variable expense | 60,000 | 0.60 | 60,000 | 0.60 | 120,000 |
| Contribution margin | \$60,000 | \$0.60 | \$20,000 | 0.20 | 80,000 |
| Fixed expense | | | | | <u>50,000</u> |
| Net income | | | | | <u>\$30,000</u> |

Required:

- Based on historical operations, K alone incurred fixed expenses of \$40,000, and L alone incurred fixed expenses of \$20,000. Find the break-even point in sales dollars and units for each product separately.
- Give reasons why the fixed costs for the two products combined are expected to be less than the sum of the fixed costs of each product line operating as a separate business.
- Assuming that for each unit of K sold, one unit of L is sold, find the break-even point in sales dollars and units for each product.

- Break-even when products have separate fixed costs:

| | <u>Line K</u> | <u>Line L</u> |
|--------------------------------------|-----------------|-----------------|
| Fixed costs | \$40,000 | \$20,000 |
| Divided by contribution margin | <u>\$0.60</u> | <u>\$0.20</u> |
| Break-even in units | 66,667 units | 100,000 units |
| Times sales price | <u>\$1.20</u> | <u>\$0.80</u> |
| Break-even in sales revenue | <u>\$80,000</u> | <u>\$80,000</u> |

b. Cost sharing of facilities, functions, systems, and management. That is, the existence of economies of scope allows common resources to be shared. For example, a smaller purchasing department is required if K and L are produced in the same plant and share a single purchasing department than if they are produced separately with their own purchasing departments.

c. Break-even when products have common fixed costs and are sold in bundles with equal proportions:

At break-even we expect:

Contribution from K + Contribution from L = Fixed costs

$$\$0.60 Q + \$0.20 Q = \$50,000$$

where Q = number of units sold of K = number of units sold of L

$$\$0.80 Q = \$50,000$$

$$Q = 62,500 \text{ units}$$

| | Break-even | | Break-even |
|----------------|-------------------|--------------|-------------------|
| Product | Units | Price | Sales |
| K | 62,500 | \$1.20 | \$75,000 |
| L | 62,500 | \$0.80 | \$70,000 |

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

Topic: Multiple Products

29. Average versus Variable Cost

Measer Enterprises produces energy-efficient light bulbs and operates in a highly competitive market in which the bulbs are sold for \$4.50 each. Because of the nature of the production technology, the firm can produce only between 10,000 and 13,000 units per month, in fixed increments of 1,000 units. Measer has the following cost structure:

| Production and Cost Data | | | | |
|--------------------------|-----------------|-----------------|-----------------|-----------------|
| | Units Produced | | | |
| | <u>10,000</u> | <u>11,000</u> | <u>12,000</u> | <u>13,000</u> |
| Factory cost, variable | \$37,000 | \$40,800 | \$44,600 | \$48,400 |
| Factory cost, fixed | 9,000 | 9,000 | 9,000 | 9,000 |
| Selling cost, variable | 6,000 | 6,600 | 7,400 | 8,200 |
| Administration, fixed | 6,000 | 6,000 | 6,000 | 6,000 |
| Total | <u>\$58,000</u> | <u>\$62,400</u> | <u>\$67,000</u> | <u>\$71,600</u> |
| Average unit cost | <u>\$5.80</u> | <u>\$5.67</u> | <u>\$5.58</u> | <u>\$5.51</u> |

Required:

At what output level should the firm operate?

"Beware of unit costs." If you focus solely on the unit cost numbers in the problem, you are likely to be misled.

In the long run, the firm should shut down because it cannot cover fixed costs. However, if the firm has already incurred or is liable for fixed factory and administration costs, then it should continue to operate if it can cover variable costs. Notice the assumption regarding timing. Fixed costs are assumed to have been incurred whereas variable costs are assumed not to have been incurred yet. Given these assumptions, the loss-minimizing rate of output is 11 million units:

| Rate of Production and Sale (000's units) | | | | |
|---|------------|------------|------------|------------|
| | 10,000 | 11,000 | 12,000 | 13,000 |
| Sales @ \$4.50/unit | \$45,000 | \$49,500 | \$54,000 | \$58,500 |
| Total Costs | 58,000 | 62,400 | 67,000 | 71,600 |
| Profit (Loss) | (\$13,000) | (\$12,900) | (\$13,000) | (\$13,100) |

Notice, minimizing average unit costs is not the basis for choosing output levels. Average unit costs are minimized at 13 million units.

An alternative way to solve the problem is to calculate contribution margin, as below:

| | OUTPUT LEVELS | | | |
|--|---------------|----------|----------|----------|
| | 10,000 | 11,000 | 12,000 | 13,000 |
| Variable Cost | \$43,000 | \$47,400 | \$52,000 | \$56,600 |
| Average Variable Cost/unit | \$4.30 | \$4.31 | \$4.33 | \$4.35 |
| Contribution margin/unit | \$.20 | \$.19 | \$.17 | \$.15 |
| Contribution margin (units × output level) | \$2,000 | \$2,090 | \$2,040 | \$1,950 |

The preceding table indicates that maximizing contribution margin (not contribution margin per unit) also gives the right answer. At 11 million units, \$2,090 is being generated towards covering fixed costs.

Minimizing average variable cost gives the wrong answer.

AACSB: Analytical Thinking

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Difficulty: 3 Hard

Topic: Copier Example

Topic: Fixed, Marginal, and Average Costs

Topic: Linear Approximations

30. Break-even Analysis

The MedView brochure said, "Only 45 scans per month to cover the monthly equipment rental of \$18,000." The footnote at the bottom of the brochure read: "Assumes a reimbursable fee of \$475 per scan."

The MedView brochure refers to a new radiology imaging system that MedView rents for \$18,000 per month. A "scan" refers to one imaging session that is billed at \$475 per scan. Each scan involves giving the patient a chemical injection and requires exposing and developing an X-ray negative.

Required:

- What variable cost per scan is MedView assuming in calculating the 45-scans-per-month amount?
- Is the MedView brochure really telling the whole financial picture? What is it omitting?

a. The brochure gives the break-even point and the question asks us to calculate variable cost per unit. Or,

| | | |
|----|---|---|
| BE | = | $\frac{\text{Fixed Cost}}{\text{Price} - \text{Variable Cost}}$ |
|----|---|---|

Substituting in the known quantities yields:

| | | |
|----|---|---|
| 45 | = | $\frac{\$18,000}{\$475 - \text{Variable Cost}}$ |
|----|---|---|

Solving for the unknown variable cost per unit gives

Variable cost = \$75/scan

- The brochure is overlooking the additional fixed costs of office space and additional

variable (or fixed) costs of the operator, utilities, maintenance, insurance and litigation, etc. Also overlooked is the required rate of return (cost of capital). Calculating the break-even point for the machine rental fee is very misleading.

AACSB: Analytical Thinking

AACSB: Communication

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

AICPA: FN Risk Analysis

Blooms: Analyze

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

Topic: Fixed, Marginal, and Average Costs

31. Break-even Analysis

Exotic Roses, owned by Margarita Rameriz, provides a variety of rare rose bushes to local nurseries that sell Rameriz's roses to the end consumer (landscapers and retail customers). Rameriz grows the roses from cuttings that she has specifically cultivated for their unusual characteristics (color, size, heartiness, and resistance to disease). Margarita's roses are in great demand as evidenced by the wholesale price she charges nurseries, \$15 per potted plant. Exotic Roses has the following cost structure (variable costs are per potted plant):

| | Fixed Costs per Year | Variable Costs |
|-----------------|----------------------|----------------|
| Plant materials | | \$0.50 |
| Pot | | 0.30 |
| Labor | \$8,000 | 0.70 |
| Utilities | 9,000 | |
| Rent | 7,500 | |
| Other costs | 2,500 | |

Required:

- How many potted rose plants must Exotic Roses sell each year to break even?
- If Rameriz wants to make profits of \$10,000 before taxes per year, how many potted rose plants must be sold?
- If Rameriz wants to make profits of \$10,000 after taxes per year, how many potted rose plants must be sold assuming a 35 percent income tax rate?

a. Fixed costs total \$27,000 per year and variable costs are \$1.50 per plant. The break-even number of potted roses is found by solving the following equation for Q:

$$\text{Profits} = \$15 Q - \$1.50 Q - \$27,000 = 0$$

$$\text{Or } Q = \$27,000/(\$15 - \$1.50) = \$27,000/\$13.50 = 2,000 \text{ plants}$$

b. To make \$10,000 of profits before taxes per year, solve the following equation for Q:

$$\text{Profits} = \$15 Q - \$1.50 Q - \$27,000 = \$10,000$$

$$\text{Or } Q = \$37,000/(\$15 - \$1.50) = \$37,000/\$13.50 = 2,740.74 \text{ plants}$$

c. To make \$10,000 of profits AFTER taxes per year, solve the following equation for Q:

$$\text{Profits} = [\$15 Q - \$1.50 Q - \$27,000] \times (1 - 0.35) = \$10,000$$

$$= [\$15 Q - \$1.50 Q - \$27,000] = \$10,000 / 0.65 = \$15,384.62$$

$$\text{Or, } Q = \$42,384.62 / \$13.50 = 3,139.60 \text{ plants}$$

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

32. Break-even Analysis

You are evaluating ways to expand an optometry practice and its earnings capacity. Optometrists perform eye exams, prescribe corrective lenses (eyeglasses and contact lenses), and sell corrective lenses. One way to expand the practice is to hire an additional optometrist. The annual cost of the optometrist, including salary, benefits, and payroll taxes, is \$63,000. You estimate that this individual can conduct two exams per hour at an average price to the patient of \$45 per exam. The new optometrist will work 40-hour weeks for 48 weeks per year. However, because of scheduling conflicts, patient no-shows, training, and other downtime, the new optometrist will not be able to conduct, bill, and collect 100 percent of his or her available examination time.

From past experience, you know that each eye exam drives additional product sales. Each exam will lead to either an eyeglass sale with a net profit (revenue less cost of sales) of \$90 (not including the exam fee) or a contact lens sale with net profits of \$65 (not including the exam fee). On average, 60 percent of the exams lead to eyeglass sales, 20 percent lead to contact lens sales, and 20 percent of the exams lead to no further sales.

Besides the salary of the optometrist, additional costs to support the new optometrist include:

| | |
|------------------------|---------------|
| Office occupancy costs | \$1,200/year |
| Leased equipment | \$330/year |
| Office staff | \$23,000/year |

Required:

In terms of the percentage of available time, what is the minimum level of examinations the new optometrist must perform to recover all the incremental costs of being hired?

Hiring the optometrist generates two income streams, examination revenue and eyeglass and contact sales. Each exam is expected to produce the following additional revenue:

| | Frequency (1) | Profits (2) | Expected Profits (1) × (2) |
|------------------------------|------------------|----------------|----------------------------------|
| Eyeglasses | 60% | \$90 | \$54 |
| Contact lens | 20% | \$65 | <u>\$13</u> |
| Expected profits per exam | | | <u>\$67</u> |

The break-even point is calculated as follows:

| | |
|--------------------------------|--------------|
| Contribution margin per exam: | |
| Exam fee | \$45 |
| Expected gross margin on sales | <u>\$67</u> |
| Contribution margin | <u>\$112</u> |

| | |
|-------------------|-----------------|
| Fixed costs: | |
| Optometrist | \$63,000 |
| Occupancy costs | 1,200 |
| Equipment | 330 |
| Office staff | <u>23,000</u> |
| Total fixed costs | <u>\$87,530</u> |

| | | |
|-------------------------------|---|---|
| Break even volume of exams | = | $\frac{\text{Total fixed costs}}{\text{Contribution margin}}$ |
| | = | $\frac{\$87,530}{\$112}$ |
| | = | 781.5 exams |

| | |
|---|---|
| Break even volume as a fraction of capacity | |
| = | $\frac{781.5 \text{ exams}}{2 \times 40 \times 48}$ |
| = | 20.3% |

AACSB: Knowledge Application

AICPA: BB Industry

AICPA: FN Decision Making

Blooms: Apply

Difficulty: 3 Hard

Topic: Calculating Break-Even and Target Profits

Topic: Copier Example