Prestige Telephone Company

- case study -

No.1: **Appraise the results of operations of Prestige Data Services. Is the subsidiary really a problem to Prestige Telephone Company? Consider carefully the differences between reported costs and costs relevant for decisions that Daniel Rowe is considering.**

Variable costs are the only costs that should be considered when making decisions according to the customary rules in accounting. The opportunity cost of the leases for the computer equipment, which had four years left and are non-cancelable. The purpose of the company was to step towards deregulation and would decrease the need for a rate increase. If the intent is to shut down Data Services they would have to pay an outside company to provide this service to Prestige Telephone Company with the loss of the revenue from commercial sales. Regarding the space that Prestige Data Services is currently using, they could potentially rent out the space to an outside company. It appears to be beneficial to lay off the personnel, wages and salaries would not be needed to pay.

The short term outlook analysis from January to March financial results cannot be concludent to make a final decision. Short-term projections should not determine retention or shut down situation decisions. I believe that retaining Prestige Data Services is better than shutting it down due to its possibility of becoming an income generator in near future.

No: 2: **Assuming the company demand for service will average 205 hours per month, what level of commercial sales of computer use would be necessary to break even each month?**

For calculating the level of commercial sales of computer use, we need to determine fixed and variable costs.

The variable costs are power and part of operations salaries.

Total power cost for 3months is = ($1633+ $1592+$1803) = $5028

The computers were is use for 1110 hours

Variable cost – Powers Cost per hour = $5028/ 1110 hours = $4.53

Total operations expense = $88,944

Total hours of computer use = 1110 hours

Variable cost – operations wages is = $88944/ 1110 = $80.13

Contribution margin is = (Selling Price – Variable cost per unit) = $800 – ($4.53 + $80.13) = $715.34

Prestige Telephone Company has an agreement with the Prestige Data Service to cover $82,000 of the costs.

Break-even analysis = Total Fixed Costs – (Cost Covering by PTC – Average monthly hours X Variable cost per unit) / Contribution Margin

= 191,037 – (82000- 205 X84.66) / 715.34 = 126,392.30 / 715.34 = 176.69 (estimated) hours

Taking 176.69 hours times the $800 per hour for commercial sales would result in break even revenue of $141,352 that would be needed each month.

No: 3: **Estimate the effect on income of each of the options Rowe has suggested if Bradley estimates as follows:**

a. Increasing the price to commercial customers to $1000 per hour would reduce demand by 30%.

In March 1997, commercial demand was for 138 hours, and a 30% reduction would leave demand of 97 hours (138 hours X 0.70 = 96.6 hours)

Demand x Contribution per Hour = $1000- ($84.66 X 96.6 hours) = $915.34 X 96.6 hours

=$88,421.85 (Estimated)

Compare to Present: 138 hours X ($800-$84.66) = $98,716.92

The monthly contribution to fixed costs and income at $800 is greater by $10,295.07 than the contribution expected at $1000. Therefore, the income will be higher if we retain that $800/ hour price.

b. Reducing the price to commercial customers to $600 per hour would increase demand by 30 %.

In March 1997, commercial demand was 138 hours

30% increase would give demand of 179.4 hours (138 hours X 1.30 = 179.4 hours)

179.4 hours X ($600- $84.66) = $92,451.70 (estimated)

Compared to present contribution of $98,716.92, a price reduction would apparently reduce profit by $6265.22 per month.

c. Increased promotion would increase sales by up to 30 percent. Bradley is unsure how much promotion this would take.

An increase in promotion that would increase commercial sales by 30% would increase sales to 179.4 hours per month. At $800 per hour, the total contribution would be:

179 hours X ($800 – $84.66) = $128,045.86

An amount up to the difference between this new contribution and the present contribution of $98,716.92 or $ 29,328.94 could be spent without reducing income.

d. Reducing operations to 16 hours on weekdays and eight hours on Saturdays would result in a loss of 20 percent of commercial revenue hours.

Reducing hours would reduce demand for revenue hours by 20%, from 138 hours to 110 (138 hours X 0.80 = 110 hours) hours. At that level, the total contribution would be,

110 hours X ($800-$84.66) = 110 hours X $ 715.34 = $78,687.40

So, it is ($98,716.92 -$78,687.40) = $20,029.52 at present.

Except for wages and potentially materials and supplies, most likely the other expenses would not be affected by this reduction of service and revenue.

No: 4: **Can you suggest changes in the accounting and reporting system now used for operations of Prestige Data Services which would result in more useful information for Rowe and Bradley?**

Prestige Data services can be suggested to use consolidated financial statements for the core and subsidiaries as these statements will show the true contribution that the Prestige Data Service is providing for Prestige Telephone Company. There are certain costs within Prestige Date that benefit the main company but they are only being seen as expenses to Prestige Data Services and are not showing how these services are providing revenue for Prestige Telephone Company.

I believe that Prestige Data Services should consider the variable costs and not just all reported costs when making decisions.