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August 14th, 2021

Case Study 2: Prestige

Assuming the company (Prestige Telephone 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?

1. Fixed costs = $190,319 = ($9,240 Rent and custody + $95,000 Leases + $5,400 maintenance + $26,180 Depreciation + $206.6 Power + Salaries [2])

2. Salaries are paid regardless of the number of hours sold, therefore the total salaries per month are: Maintenance $12,000 + Administration $9,000 + Sales $11,200 and Operations $22,093*

*Operations base salaries can be calculated with the high and low method. The running of the center is done by these employees also regardless of sales:

- (Highest Operations Salary $30,264 – Lowest operation Salary $29,184) / (Highest Hour operation 401 – Lowest Hour operation 348) = $3.98 per operating hour

- (Highest Operations Salary $30,264 - $3.98 x Highest Hour operation 401) = $22,093

3. For the variable costs there is also an amount related to power consumption:

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- (Highest Power Expense \$1,803 – Lowest operation Salary \$1,592) / (Highest Hour operation 401 – Lowest Hour operation 348) = \$20.38 per operating hour

- Commercial sales are set at a price of \$800 per hour. With Variable Costs being \$3.98 Operation + \$20.38 power = \$24.36 per commercial hour sold.

<u>Unit Contribution Margin = \$775.64 </u>= \$800 - \$24.36

4. Assuming the service to Prestige Telephone Company will average 205 as a fixed number and that the cost per hour is \$24.36, that is \$4,993.5 = (\$24.26 x 205) that will be added as a fixed cost. And Prestige Telephone Company will be paying Prestige Data Services \$400 per hour which amounts to \$82,000 monthly (205 x \$400). This numbers are fixed and therefore can be included in the calculation. This Income can be deducted from the fixed costs as it is a given that they will be perceived and will be used to cover them.

(Fixed Costs) / Unit Contribution Margin

(Unit Contribution Margin)/(Sale Price) = Contribution Margin Ratio

(\$775.64)/(\$800) = 97%

(\$190,319 - \$82,000 + \$4,993.5) / 97% = ***\$116,817 needed for Break Even.***

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($190,319 - $82,000 + $4,993.5) / $775.64 = ***146 commercial hours needed for Break Even.***

Estimate the effect on income (for the month of March) of each of the options Rowe has suggested if Bradley estimates as follows:

1. Increasing the price to commercial customers to $1,000 per hour would reduce demand by 30%.

   March demand for commercial hours is 138 a 30% reduction is 97 hours. Revenue at the new price would be $97,000 (97 x $1,000). Decreasing Total revenue to $198,886

   Operation Salary would decrease to $29,428.5; power would decrease to $1,639.8. Decreasing Expenses to $232,724.

   ($232,724 - $198,886) = - $33,838

   The Changes would result in a greater loss by $12,400

2. Reducing the price to commercial customers to $600 per hour would increase demand by 30%. March demand for commercial hours is 138 a 30% increase is 180 hours. Revenue at the new price would be $108,000 (180 x $600). Decreasing Total revenue to $209,886

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Operation Salary would increase to $31,119.9; power would decrease to $1,970.2. Increasing Expenses to $234,746

($234,746- $209,886) = - $24,860

The Changes would result in a greater loss by $3,422

3. Increased promotion would increase sales by up to 30%. Bradley is unsure how much promotion this would take. (How much could be spent and still leave Prestige Data Services with no reported loss each month if commercial hours were increased 30%?)

   Keeping everything else constant, the increase in 30% demand would mean an increase in revenue to $245,885 (180 hours x $800 + other revenues). The new Net Income would be $12,162. Current promotion expense is $8,083. ***So, he could spend up to $20,245 ($8,083 + $12,162) in total for sales promotion without a loss.***

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

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This would decrease total revenue by $22,080, a loss far exceeding the savings on salaries. Thus, resulting at a greater loss.

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?

I would suggest implementing a more frequent financial reporting, it is mentioned that it is monitored quarterly, this is too long a period to notice cost, revenues and expenses behaviors.

I would redefine the cost structure, as to truly make a distinction between variable and fixe. For example, Power is listed under the fixed costs, but it has a proportion that corresponds to variable. Same goes for the Operations Salaries, the variable part of it could be separated to human labor variable cost and included in the hour costs.

Keep an eye on Available Hours, the cost of these can be calculated. They are sunk costs since no revenue r4eswults from them.

It is mentioned that the true value from PDS to PTC is obscure and unsure, they should include clearly all the accounting entries from the subsidiary in PTC.

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Finally, I would suggest that they do more analysis regarding projections of what could be the outcome of changes in downtime, sales, prices and costs.