Student's Name: John Mustapha Kutiyote

Course: Accounting and Control

University Name: Hayek Global College

Case 2 Assignment on the Prestige Telephone Company

1. Appraise the results of operation of Prestige Data Service. Is the subsidiary really a problem to Prestige Telephone Company? Consider carefully the differences between reported costs and cost relevant for decisions that Daniel Rowe is considering.

   In order to decide on whether or not the Prestige Data Services is a problem to Prestige Telephone Company, it is better to analyze the benefits and costs that are associated with both companies as a whole and as separate functioning parts. Based on the financial report in exhibit 2 for the months of January, February and March 2003, the results of operations of Prestige Data Services are rather unpleasant because Prestige Data Service reported loses in 3 months repeatedly. To begin with, the challenges faced by the Prestige Data Service Company such as late deliveries and high employees' demand for higher salaries were sort of related to the overall potential profitability of the endeavor. Considering carefully the differences between reported costs and costs relevant for decisions that Daniel Rowe is considering, fixed costs are less of an immediate concern than variable costs, but neither would constitute much of a concern at all if an appropriate marketing mix was in place to maximize revenue. While the subsidiary looks to show a loss while standing on its own, it was initially created to provide services to Prestige Telephone Company. The benefits that it provides to the parent company allow them to operate at a lower cost of service.

By looking at the shared costs that the Prestige Data Service Company and the Prestige Telephone Company have indicated that if the Prestige Data Service Company was not there, the costs of the shared services would be completely charged to the Prestige Telephone Company. Also, the services that the Prestige Data Service Company provides are at a much lower cost to the telephone company. It is hard to look at the activities in the two companies separately because they are dependent upon one another for services and that is why the subsidiary was initially created.

Prestige Data Services Company allows Prestige Telephone Services to reduce their costs of shared expenses and supply chain costs.

Based on Exhibit No.2 farther, it is observed that both fixed and variable costs are included in the report but in a real sense it is only variable cost that could be considered for making the decision.

The opportunity cost of leases for the computer equipment which had four years left and are non-concealable. The main goal of establishing the subsidiary was to deregulate and decrease the need for a rate increase. Furthermore, if the Prestige Data service Company were to be shutdown, it would pay an outside company to provide this service to the Prestige Telephone Company with the loss of revenue from the commercial sales. In reference to the space Prestige Data Service is using, they could rent the space to an outside company. Laying off some of the personnel would cut down the wages and salaries to be paid.

Looking at Exhibit 2 and analyzing it more. It is seen that the net loss is decreasing and it is assumed that in the next few months to come Prestige Data Service will start realizing some profits.

From this point of view, the subsidiary is not a problem to Prestige Telephone Company.

2. Assuming the company demand for service with average 205 hours per month, the level of commercial sales necessary for the company to break even each month. There is need to start by determining and separating the companies fixed and variable costs in order to apply the break even calculation.

   Using:

   BEP in unit=fixed cost/contribution margin

   BEP in $=fixed costs/contribution margin ratio

   Where Unit contribution margin=selling price –unit variable cost

   Therefore:

   The variable costs in exhibit 2 are power and parts of operation salaries

   The total of power=1633+1592+1803=5028

   Where the total computer hours used was 1110 hours

   Variable cost-power/hours

   5028/1110=4.53hrs

   Total operation expense=$29496+$29184+$30264=$88944

   Contribution margin=selling price-variable cost/unit

   800-(4.53+80.13) =715.34

   Note that the Prestige Data Service Company had an agreement with Prestige Telephone Company to cover $82000of the cost

   Therefore: Break Even Point=total fixed cost-(cost covered by Prestige Telephone Company-average monthly hours x variable cost/unit contribution margin

191037-(82000-205x84.7)/715.3=126392.3/715.34

=176.69hours

Therefore; 176.69x800=141352 will be needed per commercial sales would result in breakeven revenue each month.

3. The effect on income of each of the options Rowe suggested to Bradley are
    a. Increasing the price to commercial customers to $1000 per hour would reduce demand by 30%. In this case the higher the price the lower the demand thereby reducing the revenue of the subsidiary company which I think is not a good idea given the fact that the subsidiary company is already operating at a loss. This means $1000-(1000x30%) =$700 would reduce the revenue by $700.

       In March 2003, demand was for 138 hours, and a 30% reduction would put demand at 97 hours (138 hours x. 70 = 96. 6 hours). $5 Variable operation wages + $25 Fixed operation.

       Wages = $30 (Power) Demand x Contribution per hour = Contribution

       97 hours x ($1,000 – $30) = $94,090 Compared to present 138 hours x ($800 – $30) = $106,260

       The monthly contribution to fixed costs and income at $800 is greater by $12,170 than the contribution expected at $1,000. Therefore, income will be greater if we retain the $800/hour price to commercial customers.
    b. Reducing the price to commercial customers to $600 per hour would increase demand by 30%. The lower the price the higher the demand. $600+ (600x30%) =$780. This entails that the revenue of the prestige data service will increase.

According to exhibit 2 with reference to March 2003, demand was 138 hours for commercial customers, so a 30% increase would put demand at:

138 hours x 1. 30 = 179. 4 hours.

179 hours x ($600 – $30) = $102,030 Compared to present contribution of $106,260, a price reduction would reduce income by $4,230 per month.

c. 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%?)

   An increase in promotion that would increase commercial sales by 30% would move the hours up to 179 hours per month.

   At $800 per hour, the total contribution would be:

   179 hours x ($800 – $30) = $137,830

   An amount up to the difference between this new contribution and the present contribution of $106,260 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% of commercial revenue hours.

   In this case reducing hours would reduce demand for commercial revenue hours by 20%, from 138 hours to 110 hours.

   At that level, the total contribution would be:

   110hours x ($800 – $30) = $84,700 which is less than the current costs. A loss of $21,560 would not balance the savings of variable costs each month

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 has chosen to use the absorption costing method because variable costs and the fixed costs are all mixed in through the different categories of costs. When you use absorption costing, you do not get the true value of your expenses when it comes to an internal point of view. The operations and power costs need to be set apart from the rest of the costs.

   As such the Prestige Data Service is advised to use consolidated financial statements for both Prestige Telephone and Prestige Data Service Companies because these statements will show the true contribution of Prestige Data Service to the Prestige Telephone Company because there are some costs within the Prestige Data Service Company that benefit Prestige Telephone Company but they are treated as costs to Prestige Data Service Company. The alteration will also help set a proper price to clients and to Prestige Telephone Company such that while making decision, the Prestige Data Service Company will consider the variable costs and not just all the reported costs.