

Chapter 6

Cost-Volume-Profit Relationships

Solutions to Questions

6-1 The contribution margin (CM) ratio is the ratio of the total contribution margin to total sales revenue. It can also be expressed as the ratio of the contribution margin per unit to the selling price per unit. It is used in target profit and break-even analysis and can be used to quickly estimate the effect on profits of a change in sales revenue.

6-2 Incremental analysis focuses on the changes in revenues and costs that will result from a particular action.

6-3 All other things equal, Company B, with its higher fixed costs and lower variable costs, will have a higher contribution margin ratio than Company A. Therefore, it will tend to realize a larger increase in contribution margin and in profits when sales increase.

6-4 Operating leverage measures the impact on net operating income of a given percentage change in unit sales. The degree of operating leverage at a given level of sales is computed by dividing the contribution margin at that level of sales by the net operating income at that level of sales.

6-5 The break-even point is the level of sales at which profits are zero.

6-6 (a) If the selling price decreased, then the total revenue line would rise less steeply, and the break-even point would occur at a

higher unit volume. (b) If the fixed cost increased, then both the fixed cost line and the total cost line would shift upward and the break-even point would occur at a higher unit volume. (c) If the variable cost per unit increased, then the total cost line would rise more steeply and the break-even point would occur at a higher unit volume.

6-7 The margin of safety is the excess of budgeted (or actual) sales over the break-even volume of sales. It is the amount by which sales can drop before losses begin to be incurred.

6-8 The sales mix is the relative proportions in which a company's products are sold. The usual assumption in cost-volume-profit analysis is that the sales mix will not change.

6-9 A higher break-even point and a lower net operating income could result if the sales mix shifted from high contribution margin products to low contribution margin products. Such a shift would cause the average contribution margin ratio in the company to decline, resulting in less total contribution margin for a given amount of sales. Thus, net operating income would decline. With a lower contribution margin ratio, the break-even point would be higher because more sales would be required to cover the same amount of fixed costs.

Chapter 6: Applying Excel

The completed worksheet is shown below.

	A	B	C	D
1	Chapter 6: Applying Excel			
2				
3	Data			
4	Unit sales	20,000	units	
5	Selling price per unit	\$60	per unit	
6	Variable expenses per unit	\$45	per unit	
7	Fixed expenses	\$240,000		
8				
9	<i>Enter a formula into each of the cells marked with a ? below</i>			
10	Review Problem: CVP Relationships			
11				
12	Compute the CM ratio and variable expense ratio			
13	Selling price per unit		? per unit	
14	Variable expenses per unit		? per unit	
15	Contribution margin per unit		? per unit	
16				
17	CM ratio		?	
18	Variable expense ratio		?	
19				
20	Compute the break-even			
21	Break-even in unit sales		? units	
22	Break-even in dollar sales		?	
23				
24	Compute the margin of safety			
25	Margin of safety in dollars		?	
26	Margin of safety percentage		?	
27				
28	Compute the degree of operating leverage			
29	Sales		?	
30	Variable expenses		?	
31	Contribution margin		?	
32	Fixed expenses		?	
33	Net operating income		?	
34				
35	Degree of operating leverage		?	
36				

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Chapter 6: Applying Excel (continued)

The completed worksheet, with formulas displayed, is shown below.

	A	B	C
1	Chapter 6: Applying Excel		
2			
3	Data		
4	Unit sales	20000	units
5	Selling price per unit	60	per unit
6	Variable expenses per unit	45	per unit
7	Fixed expenses	240000	
8			
9	<i>Enter a formula into each of the cells marked with a ? below</i>		
10	Review Problem: CVP Relationships		
11			
12	Compute the CM ratio and variable expense ratio		
13	Selling price per unit	=B5	per unit
14	Variable expenses per unit	=B6	per unit
15	Contribution margin per unit	=B13-B14	per unit
16			
17	CM ratio	=B15/B13	
18	Variable expense ratio	=B14/B13	
19			
20	Compute the break-even		
21	Break-even in unit sales	=B7/B15	units
22	Break-even in dollar sales	=B7/B17	
23			
24	Compute the margin of safety		
25	Margin of safety in dollars	=B4*B5-B22	
26	Margin of safety percentage	=B25/(B4*B5)	
27			
28	Compute the degree of operating leverage		
29	Sales	=B4*B13	
30	Variable expenses	=B4*B6	
31	Contribution margin	=B29-B30	
32	Fixed expenses	=B7	
33	Net operating income	=B31-B32	
34			
35	Degree of operating leverage	=B31/B33	
36			
37			

Chapter 6: Applying Excel (continued)

- When the fixed expenses are changed to \$270,000, the worksheet changes as shown below:

	A	B	C	D	E
1	Chapter 6: Applying Excel				
2					
3	Data				
4	Unit sales	20,000	units		
5	Selling price per unit	\$60	per unit		
6	Variable expenses per unit	\$45	per unit		
7	Fixed expenses	\$270,000			
8					
9	<i>Enter a formula into each of the cells marked with a ? below</i>				
10	Review Problem: CVP Relationships				
11					
12	Compute the CM ratio and variable expense ratio				
13	Selling price per unit	\$60	per unit		
14	Variable expenses per unit	45	per unit		
15	Contribution margin per unit	\$15	per unit		
16					
17	CM ratio	25%			
18	Variable expense ratio	75%			
19					
20	Compute the break-even				
21	Break-even in unit sales	18,000	units		
22	Break-even in dollar sales	\$1,080,000			
23					
24	Compute the margin of safety				
25	Margin of safety in dollars	\$120,000			
26	Margin of safety percentage	10%			
27					
28	Compute the degree of operating leverage				
29	Sales	\$1,200,000			
30	Variable expenses	900,000			
31	Contribution margin	300,000			
32	Fixed expenses	270,000			
33	Net operating income	\$ 30,000			
34					
35	Degree of operating leverage	10.00			
36					

The margin of safety percentage is now 10%, whereas it was 20% before. This change occurred because the increase in fixed expenses increased the break-even point and hence reduced the margin of safety

available for the current level of unit sales.

Chapter 6: Applying Excel (continued)

2. With the changes in the data, the worksheet should look like this:

	A	B	C	D	E
1	Chapter 6: Applying Excel				
2					
3	Data				
4	Unit sales	10,000	units		
5	Selling price per unit	\$120	per unit		
6	Variable expenses per unit	\$72	per unit		
7	Fixed expenses	\$420,000			
8					
9	<i>Enter a formula into each of the cells marked with a ? below</i>				
10	Review Problem: CVP Relationships				
11					
12	Compute the CM ratio and variable expense ratio				
13	Selling price per unit	\$120	per unit		
14	Variable expenses per unit	72	per unit		
15	Contribution margin per unit	\$48	per unit		
16					
17	CM ratio	40%			
18	Variable expense ratio	60%			
19					
20	Compute the break-even				
21	Break-even in unit sales	8,750	units		
22	Break-even in dollar sales	\$1,050,000			
23					
24	Compute the margin of safety				
25	Margin of safety in dollars	\$150,000			
26	Margin of safety percentage	13%			
27					
28	Compute the degree of operating leverage				
29	Sales	\$1,200,000			
30	Variable expenses	720,000			
31	Contribution margin	480,000			
32	Fixed expenses	420,000			
33	Net operating income	\$ 60,000			
34					
35	Degree of operating leverage	8.00			
36					

The margin of safety percentage is 13% and the degree of operating leverage is 8.

Chapter 6: Applying Excel (continued)

3. The degree of operating leverage can be used to estimate the expected percentage increase in net operating income from a 15% increase in unit sales as follows:

Percentage change in net operating income = Degree of operating leverage \times Percentage change in sales = $8.00 \times 15\% = 120\%$

An increase of 120% over the current net operating income of \$60,000 would result in net operating income of \$132,000. This is verified in part (4) that follows.

Chapter 6: Applying Excel (continued)

4. Increasing the unit sales by 15% results in net operating income of \$132,000—an increase of 120% over the previous net operating income of \$60,000.

	A	B	C	D	E
1	Chapter 6: Applying Excel				
2					
3	Data				
4	Unit sales	11,500	units		
5	Selling price per unit	\$120	per unit		
6	Variable expenses per unit	\$72	per unit		
7	Fixed expenses	\$420,000			
8					
9	<i>Enter a formula into each of the cells marked with a ? below</i>				
10	Review Problem: CVP Relationships				
11					
12	Compute the CM ratio and variable expense ratio				
13	Selling price per unit	\$120	per unit		
14	Variable expenses per unit	72	per unit		
15	Contribution margin per unit	\$48	per unit		
16					
17	CM ratio	40%			
18	Variable expense ratio	60%			
19					
20	Compute the break-even				
21	Break-even in unit sales	8,750	units		
22	Break-even in dollar sales	\$1,050,000			
23					
24	Compute the margin of safety				
25	Margin of safety in dollars	\$330,000			
26	Margin of safety percentage	24%			
27					
28	Compute the degree of operating leverage				
29	Sales	\$1,380,000			
30	Variable expenses	828,000			
31	Contribution margin	552,000			
32	Fixed expenses	420,000			
33	Net operating income	\$ 132,000			
34					
35	Degree of operating leverage	4.18			
36					

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Chapter 6: Applying Excel (continued)

5. a. The initial plan for the Western Hombre motorcycle is summarized below:

	A	B	C	D	E
1	Chapter 6: Applying Excel				
2					
3	Data				
4	Unit sales	600	units		
5	Selling price per unit	\$10,000	per unit		
6	Variable expenses per unit	\$7,500	per unit		
7	Fixed expenses	\$1,200,000			
8					
9	Enter a formula into each of the cells marked with a ? below				
10	Review Problem: CVP Relationships				
11					
12	Compute the CM ratio and variable expense ratio				
13	Selling price per unit	\$10,000	per unit		
14	Variable expenses per unit	7,500	per unit		
15	Contribution margin per unit	\$2,500	per unit		
16					
17	CM ratio	25%			
18	Variable expense ratio	75%			
19					
20	Compute the break-even				
21	Break-even in unit sales	480	units		
22	Break-even in dollar sales	\$4,800,000			
23					
24	Compute the margin of safety				
25	Margin of safety in dollars	\$1,200,000			
26	Margin of safety percentage	20%			
27					
28	Compute the degree of operating leverage				
29	Sales	\$6,000,000			
30	Variable expenses	4,500,000			
31	Contribution margin	1,500,000			
32	Fixed expenses	1,200,000			
33	Net operating income	\$ 300,000			
34					
35	Degree of operating leverage	5.00			
36					

Chapter 6: Applying Excel (continued)

5. b. The modified plan for the Western Hombre motorcycle is summarized below:

	A	B	C	D	E
1	Chapter 6: Applying Excel				
2					
3	Data				
4	Unit sales	600	units		
5	Selling price per unit	\$9,000	per unit		
6	Variable expenses per unit	\$7,500	per unit		
7	Fixed expenses	\$900,000			
8					
9	<i>Enter a formula into each of the cells marked with a ? below</i>				
10	Review Problem: CVP Relationships				
11					
12	Compute the CM ratio and variable expense ratio				
13	Selling price per unit	\$9,000	per unit		
14	Variable expenses per unit	7,500	per unit		
15	Contribution margin per unit	\$1,500	per unit		
16					
17	CM ratio	17%			
18	Variable expense ratio	83%			
19					
20	Compute the break-even				
21	Break-even in unit sales	600	units		
22	Break-even in dollar sales	\$5,400,000			
23					
24	Compute the margin of safety				
25	Margin of safety in dollars	\$0			
26	Margin of safety percentage	0%			
27					
28	Compute the degree of operating leverage				
29	Sales	\$5,400,000			
30	Variable expenses	4,500,000			
31	Contribution margin	900,000			
32	Fixed expenses	900,000			
33	Net operating income	\$ -			
34					
35	Degree of operating leverage	#DIV/0!			
36					

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Chapter 6: Applying Excel (continued)

This does not appear to be a good plan. At best, Thad would only break even—and that assumes that 600 units would still be sold despite the drastic reduction in advertising expenses. The margin of safety is zero which means that any decrease in sales to below 600 units would result in a loss.

The degree of operating leverage is displayed in the worksheet as #DIV/0!. This means that Excel is unable to compute the degree of operating leverage because the divisor is 0. The divisor is 0 because the degree of operating leverage is the contribution margin divided by the net operating income and the net operating income is zero. Technically, the degree of operating leverage is undefined when net operating income is zero.

The Foundational 15

1. The contribution margin per unit is calculated as follows:

Total contribution margin (a)	\$8,000
Total units sold (b)	1,000 units
Contribution margin per unit (a) ÷ (b) .	\$8.00 per unit

The contribution margin per unit (\$8) can also be derived by calculating the selling price per unit of \$20 (= \$20,000 ÷ 1,000 units) and deducting the variable expense per unit of \$12 (= \$12,000 ÷ 1,000 units).

2. The contribution margin ratio is calculated as follows:

Total contribution margin (a)	\$8,000
Total sales (b)	\$20,000
Contribution margin ratio (a) ÷ (b).....	40%

3. The variable expense ratio is calculated as follows:

Total variable expenses (a).....	\$12,000
Total sales (b)	\$20,000
Variable expense ratio (a) ÷ (b).....	60%

4. The increase in net operating income is calculated as follows:

Contribution margin per unit (a).....	\$8.00 per unit
Increase in unit sales (b)	1 unit
Increase in net operating income (a) × (b) ..	\$8.00

5. If sales decline to 900 units, the net operating income would be computed as follows:

	<i>Total</i>	<i>Per Unit</i>
Sales (900 units).....	\$18,000	\$20.00
Variable expenses	<u>10,800</u>	<u>12.00</u>
Contribution margin	7,200	<u>\$ 8.00</u>
Fixed expenses	<u>6,000</u>	
Net operating income ...	<u>\$ 1,200</u>	

The Foundational 15 (continued)

6. The new net operating income would be computed as follows:

	<i>Total</i>	<i>Per Unit</i>
Sales (900 units).....	\$19,800	\$22.00
Variable expenses	<u>10,800</u>	<u>12.00</u>
Contribution margin	9,000	<u>\$10.00</u>
Fixed expenses	<u>6,000</u>	
Net operating income ...	<u>\$ 3,000</u>	

7. The new net operating income would be computed as follows:

	<i>Total</i>	<i>Per Unit</i>
Sales (1,250 units)	\$25,000	\$20.00
Variable expenses	<u>16,250</u>	<u>13.00</u>
Contribution margin	8,750	<u>\$ 7.00</u>
Fixed expenses	<u>7,500</u>	
Net operating income ...	<u>\$ 1,250</u>	

8. The equation method yields the break-even point in unit sales, Q , as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$0 &= (\$20 - \$12) \times Q - \$6,000 \\ \$0 &= (\$8) \times Q - \$6,000 \\ \$8Q &= \$6,000 \\ Q &= \$6,000 \div \$8 \\ Q &= 750 \text{ units}\end{aligned}$$

9. The equation method yields the dollar sales to break-even as follows:

$$\begin{aligned}\text{Profit} &= \text{CM ratio} \times \text{Sales} - \text{Fixed expenses} \\ \$0 &= 0.40 \times \text{Sales} - \$6,000 \\ 0.40 \times \text{Sales} &= \$6,000 \\ \text{Sales} &= \$6,000 \div 0.40 \\ \text{Sales} &= \$15,000\end{aligned}$$

The dollar sales to break-even (\$15,000) can also be computed by multiplying the selling price per unit (\$20) by the unit sales to break-even (750 units).

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The Foundational 15 (continued)

10. The equation method yields the target profit as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$5,000 &= (\$20 - \$12) \times Q - \$6,000 \\ \$5,000 &= (\$8) \times Q - \$6,000 \\ \$8Q &= \$11,000 \\ Q &= \$11,000 \div \$8 \\ Q &= 1,375 \text{ units}\end{aligned}$$

11. The margin of safety in dollars is calculated as follows:

Sales.....	\$20,000
Break-even sales (at 750 units).....	<u>15,000</u>
Margin of safety (in dollars).....	<u>\$ 5,000</u>

The margin of safety as a percentage of sales is calculated as follows:

Margin of safety (in dollars) (a).....	\$5,000
Sales (b).....	\$20,000
Margin of safety percentage (a) ÷ (b)	25%

12. The degree of operating leverage is calculated as follows:

Contribution margin (a)	\$8,000
Net operating income (b)	\$2,000
Degree of operating leverage (a) ÷ (b) ..	4.0

13. A 5% increase in unit sales should result in a 20% increase in net operating income, computed as follows:

Degree of operating leverage (a)	4.0
Percent increase in sales (b)	5%
Percent increase in net operating income (a) × (b)....	20%

14. The degree of operating leverage is calculated as follows:

Contribution margin (\$20,000 – \$6,000) (a).....	\$14,000
Net operating income (b)	\$2,000
Degree of operating leverage (a) ÷ (b)	7.0

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The Foundational 15 (continued)

15. A 5% increase in unit sales should result in a 35% increase in net operating income, computed as follows:

Degree of operating leverage (a)	7.0
Percent increase in sales (b)	5%
Percent increase in net operating income (a) × (b)	35%

Exercise 6-1 (20 minutes)

1. The revised net operating income would be:

	<i>Total</i>	<i>Per Unit</i>
Sales (10,100 units).....	\$353,500	\$35.00
Variable expenses.....	<u>202,000</u>	<u>20.00</u>
Contribution margin.....	151,500	<u>\$15.00</u>
Fixed expenses	<u>135,000</u>	
Net operating income	<u>\$ 16,500</u>	

You can get the same net operating income using the following approach:

Original net operating income....	\$15,000
Change in contribution margin (100 units × \$15.00 per unit) ..	<u>1,500</u>
New net operating income.....	<u>\$16,500</u>

2. The revised net operating income would be:

	<i>Total</i>	<i>Per Unit</i>
Sales (9,900 units)	\$346,500	\$35.00
Variable expenses.....	<u>198,000</u>	<u>20.00</u>
Contribution margin.....	148,500	<u>\$15.00</u>
Fixed expenses	<u>135,000</u>	
Net operating income	<u>\$ 13,500</u>	

You can get the same net operating income using the following approach:

Original net operating income.....	\$15,000
Change in contribution margin (-100 units × \$15.00 per unit).....	<u>(1,500)</u>
New net operating income.....	<u>\$13,500</u>

Exercise 6-1 (continued)

3. The revised net operating income would be:

	<i>Total</i>	<i>Per Unit</i>
Sales (9,000 units)	\$315,000	\$35.00
Variable expenses.....	<u>180,000</u>	<u>20.00</u>
Contribution margin.....	135,000	<u>\$15.00</u>
Fixed expenses	<u>135,000</u>	
Net operating income ...	<u>\$ 0</u>	

Note: This is the company's break-even point.

Exercise 6-2 (30 minutes)

1. The CVP graph can be plotted using the three steps outlined in the text. The graph appears on the next page.

Step 1. Draw a line parallel to the volume axis to represent the total fixed expense. For this company, the total fixed expense is \$24,000.

Step 2. Choose some volume of sales and plot the point representing total expenses (fixed and variable) at the activity level you have selected. We'll use the sales level of 8,000 units.

Fixed expenses	\$ 24,000
Variable expenses (8,000 units × \$18 per unit)	<u>144,000</u>
Total expense	<u>\$168,000</u>

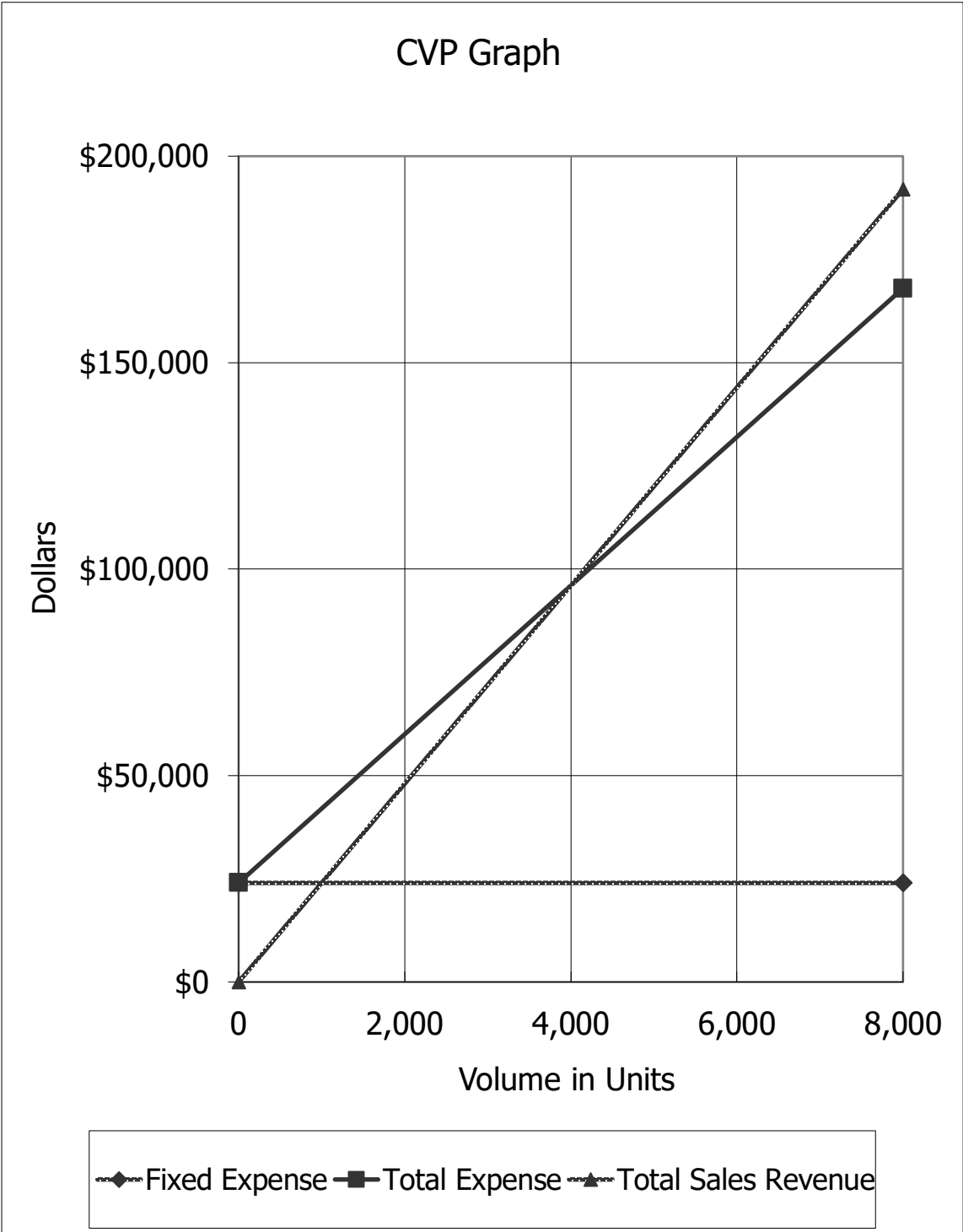
Step 3. Choose some volume of sales and plot the point representing total sales dollars at the activity level you have selected. We'll use the sales level of 8,000 units again.

Total sales revenue (8,000 units × \$24 per unit) ...	<u>\$192,000</u>
---	------------------

2. The break-even point is the point where the total sales revenue and the total expense lines intersect. This occurs at sales of 4,000 units. This can be verified as follows:

$$\begin{aligned} \text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ &= (\$24 - \$18) \times 4,000 - \$24,000 \\ &= \$6 \times 4,000 - \$24,000 \\ &= \$24,000 - \$24,000 \\ &= \$0 \end{aligned}$$

Exercise 6-2 (continued)



Exercise 6-3 (15 minutes)

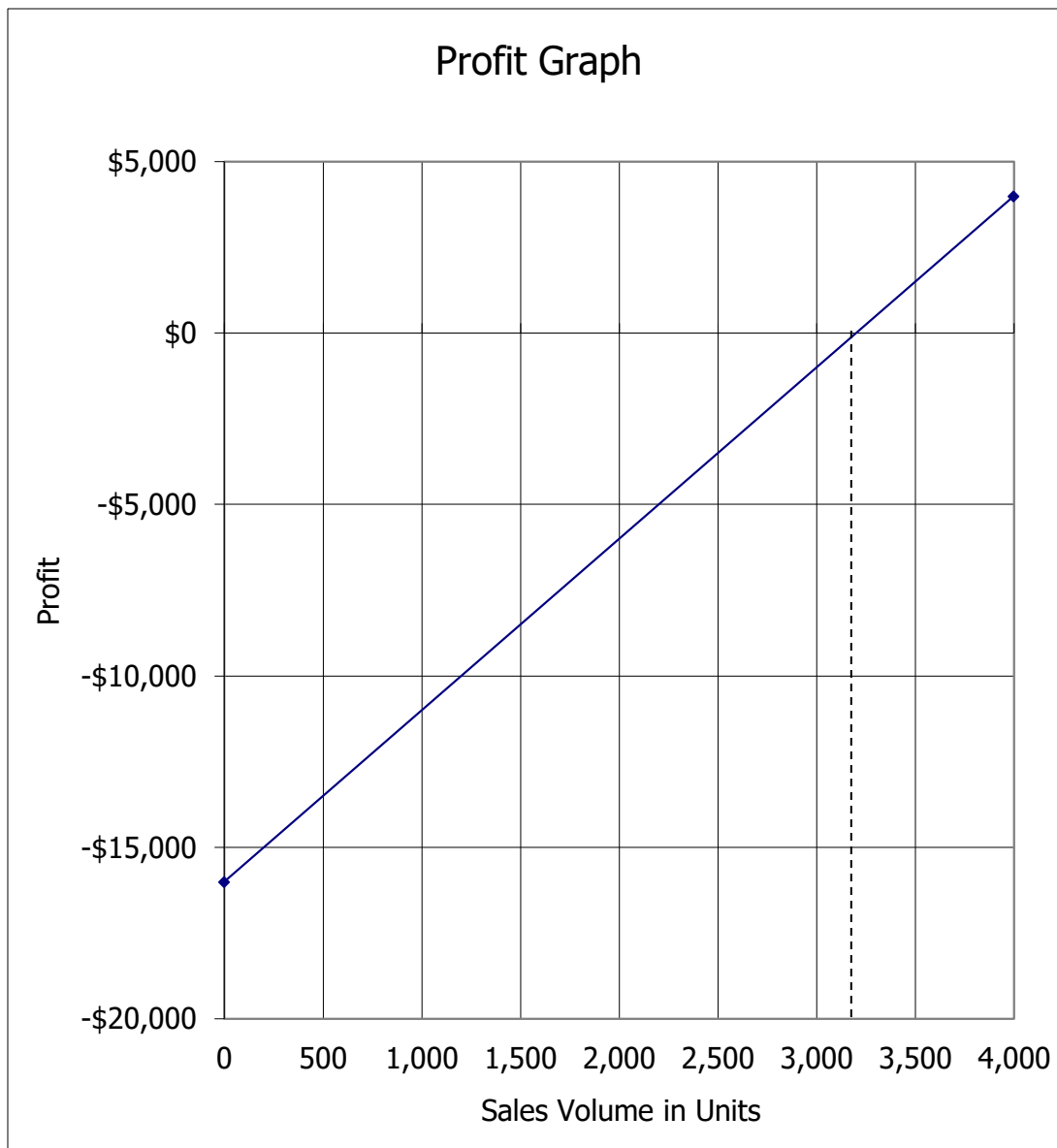
1. The profit graph is based on the following simple equation:

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\text{Profit} = (\$16 - \$11) \times Q - \$16,000$$

$$\text{Profit} = \$5 \times Q - \$16,000$$

To plot the graph, select two different levels of sales such as $Q = 0$ and $Q = 4,000$. The profit at these two levels of sales are $-\$16,000$ ($= \$5 \times 0 - \$16,000$) and $\$4,000$ ($= \$5 \times 4,000 - \$16,000$).



Exercise 6-3 (continued)

2. Looking at the graph, the break-even point appears to be 3,200 units.
This can be verified as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ &= \$5 \times Q - \$16,000 \\ &= \$5 \times 3,200 - \$16,000 \\ &= \$16,000 - \$16,000 \\ &= \$0\end{aligned}$$

Exercise 6-4 (10 minutes)

1. The company's contribution margin (CM) ratio is:

Total sales	\$200,000
Total variable expenses.....	<u>120,000</u>
Total contribution margin (a).	<u>\$ 80,000</u>

Total contribution margin (a).	\$80,000
Total sales (b).....	\$200,000
CM ratio (a) ÷ (b)	40%

2. The change in net operating income from an increase in total sales of \$1,000 can be estimated by using the CM ratio as follows:

Change in total sales (a)	\$1,000
CM ratio (b)	40%
Estimated change in net operating income (a) × (b) ..	\$400

This computation can be verified as follows:

Total sales (a).....	\$200,000
Total units sold (b)	50,000 units
Selling price per unit (a) ÷ (b) ...	\$4.00 per unit

Increase in total sales (a).....	\$1,000
Selling price per unit (b).....	\$4.00 per unit
Increase in unit sales (a) ÷ (b) ..	250 units

Increase in unit sales	250 units
Original total unit sales	<u>50,000</u> units
New total unit sales	<u>50,250</u> units

	<i>Original</i>	<i>New</i>
Total unit sales.....	<u>50,000</u>	<u>50,250</u>
Sales	\$200,000	\$201,000
Variable expenses.....	<u>120,000</u>	<u>120,600</u>
Contribution margin.....	80,000	80,400
Fixed expenses	<u>65,000</u>	<u>65,000</u>
Net operating income	<u>\$ 15,000</u>	<u>\$ 15,400</u>

Exercise 6-5 (20 minutes)

1. The following table shows the effect of the proposed change in monthly advertising budget:

	<i>Current Sales</i>	<i>Sales With Additional Advertising Budget</i>	<i>Difference</i>
Sales.....	\$180,000	\$189,000	\$ 9,000
Variable expenses.....	<u>126,000</u>	<u>132,300</u>	<u>6,300</u>
Contribution margin.....	54,000	56,700	2,700
Fixed expenses	<u>30,000</u>	<u>35,000</u>	<u>5,000</u>
Net operating income	<u>\$ 24,000</u>	<u>\$ 21,700</u>	<u>\$ (2,300)</u>

Assuming no other important factors need to be considered, the increase in the advertising budget should not be approved because it would lead to a decrease in net operating income of \$2,300.

Alternative Solution 1

Expected total contribution margin:	
\$189,000 × 30% CM ratio	\$56,700
Present total contribution margin:	
\$180,000 × 30% CM ratio	<u>54,000</u>
Incremental contribution margin	2,700
Change in fixed expenses:	
Less incremental advertising expense .	<u>5,000</u>
Change in net operating income.....	<u>\$ (2,300)</u>

Alternative Solution 2

Incremental contribution margin:	
\$9,000 × 30% CM ratio	\$2,700
Less incremental advertising expense	<u>5,000</u>
Change in net operating income.....	<u>\$ (2,300)</u>

Exercise 6-5 (continued)

2. The \$2 increase in variable expense will cause the unit contribution margin to decrease from \$27 to \$25 with the following impact on net operating income:

Expected total contribution margin with the higher-quality components:	
2,000 units × 1.1 × \$25 per unit	\$55,000
Present total contribution margin:	
2,000 units × \$27 per unit	<u>54,000</u>
Change in total contribution margin.....	<u>\$ 1,000</u>

Assuming no change in fixed expenses, the net operating income will also increase by \$1,000. The higher-quality components should be used.

Exercise 6-6 (20 minutes)

1. The break-even point in unit sales, Q , is computed as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$0 &= (\$15 - \$12) \times Q - \$4,200 \\ \$0 &= (\$3) \times Q - \$4,200 \\ \$3Q &= \$4,200 \\ Q &= \$4,200 \div \$3 \\ Q &= 1,400 \text{ baskets}\end{aligned}$$

2. The break-even point in dollar sales is computed as follows:

Unit sales to break even (a).....	1,400
Selling price per unit (b).....	\$15
Dollar sales to break even (a) \times (b).....	\$21,000

3. The new break-even point in unit sales, Q , is computed as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$0 &= (\$15 - \$12) \times Q - \$4,800 \\ \$0 &= (\$3) \times Q - \$4,800 \\ \$3Q &= \$4,800 \\ Q &= \$4,800 \div \$3 \\ Q &= 1,600 \text{ baskets}\end{aligned}$$

The break-even point in dollar sales is computed as follows:

Unit sales to break even (a).....	1,600
Selling price per unit (b).....	\$15
Dollar sales to break even (a) \times (b).....	\$24,000

Exercise 6-7 (10 minutes)

1. The required unit sales, Q , to attain the target profit is computed as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$10,000 &= (\$120 - \$80) \times Q - \$50,000 \\ \$10,000 &= (\$40) \times Q - \$50,000 \\ \$40 \times Q &= \$10,000 + \$50,000 \\ Q &= \$60,000 \div \$40 \\ Q &= 1,500 \text{ units}\end{aligned}$$

2. One approach to solving this requirement is to compute the unit sales required to attain the target profit and then multiply this quantity by the selling price per unit:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$15,000 &= (\$120 - \$80) \times Q - \$50,000 \\ \$15,000 &= (\$40) \times Q - \$50,000 \\ \$40 \times Q &= \$15,000 + \$50,000 \\ Q &= \$65,000 \div \$40 \\ Q &= 1,625 \text{ units}\end{aligned}$$

Unit sales to attain the target profit (a).....	1,625
Selling price per unit (b).....	\$120
Dollar sales to attain target profit (a) \times (b)	\$195,000

Exercise 6-8 (10 minutes)

1. To compute the margin of safety, we must first compute the break-even unit sales.

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = (\$30 - \$20) \times Q - \$7,500$$

$$\$0 = (\$10) \times Q - \$7,500$$

$$\$10Q = \$7,500$$

$$Q = \$7,500 \div \$10$$

$$Q = 750 \text{ units; or, at } \$30 \text{ per unit, } \$22,500$$

Sales (at the budgeted volume of 1,000 units) .	\$30,000
Less break-even sales (at 750 units)	<u>22,500</u>
Margin of safety (in dollars).....	<u>\$ 7,500</u>

2. The margin of safety as a percentage of sales is as follows:

$$\text{Margin of safety (in dollars) (a)..... } \$7,500$$

$$\text{Sales (b)..... } \$30,000$$

$$\text{Margin of safety percentage (a) } \div \text{ (b) } 25\%$$

Exercise 6-9 (20 minutes)

1. The company's degree of operating leverage would be computed as follows:

Contribution margin (a).....	\$48,000
Net operating income (b)	\$10,000
Degree of operating leverage (a) ÷ (b)....	4.8

2. A 5% increase in unit sales should result in a 24% increase in net operating income, computed as follows:

Degree of operating leverage (a)	4.8
Percent increase in unit sales (b)	5%
Estimated percent increase in net operating income (a) × (b).	24%

3. The new income statement reflecting the change in unit sales is:

	<i>Amount</i>	<i>Percent of Sales</i>
Sales	\$84,000	100%
Variable expenses.....	<u>33,600</u>	<u>40%</u>
Contribution margin.....	50,400	<u>60%</u>
Fixed expenses	<u>38,000</u>	
Net operating income ...	<u>\$12,400</u>	
Net operating income reflecting change in sales	\$12,400	
Original net operating income (a).....	<u>10,000</u>	
Change in net operating income (b)	<u>\$ 2,400</u>	
Percent change in net operating income (b) ÷ (a) ...		24%

Exercise 6-10 (20 minutes)

1. The overall contribution margin ratio can be computed as follows:

$$\begin{aligned} \text{Overall CM ratio} &= \frac{\text{Total contribution margin}}{\text{Total sales}} \\ &= \frac{\$30,000}{\$100,000} = 30\% \end{aligned}$$

2. The overall break-even point in dollar sales can be computed as follows:

$$\begin{aligned} \text{Overall break-even} \\ &= \$80,000 \end{aligned}$$

3. To construct the required income statement, we must first determine the relative sales mix for the two products:

	<i>Claimjumper</i>	<i>Makeover</i>	<i>Total</i>
Original dollar sales	\$30,000	\$70,000	\$100,000
Percent of total	30%	70%	100%
Sales at break-even	\$24,000	\$56,000	\$80,000

	<i>Claimjumper</i>	<i>Makeover</i>	<i>Total</i>
Sales	\$24,000	\$56,000	\$80,000
Variable expenses*	<u>16,000</u>	<u>40,000</u>	<u>56,000</u>
Contribution margin	<u>\$ 8,000</u>	<u>\$16,000</u>	24,000
Fixed expenses			<u>24,000</u>
Net operating income ...			<u>\$ 0</u>

*Claimjumper variable expenses: $(\$24,000/\$30,000) \times \$20,000 = \$16,000$

Makeover variable expenses: $(\$56,000/\$70,000) \times \$50,000 = \$40,000$

Exercise 6-11 (20 minutes)

a.		<u>Case #1</u>		<u>Case #2</u>	
	Number of units sold ...	<u>15,000</u> *		<u>4,000</u>	
	Sales	\$180,000 *	\$12	\$100,000 *	\$25
	Variable expenses	<u>120,000</u> *	<u>8</u>	<u>60,000</u>	<u>15</u>
	Contribution margin	60,000	<u>\$ 4</u>	40,000	<u>\$10</u> *
	Fixed expenses	<u>50,000</u> *		<u>32,000</u> *	
	Net operating income ..	<u>\$ 10,000</u>		<u>\$ 8,000</u> *	

		<u>Case #3</u>		<u>Case #4</u>	
	Number of units sold ...	<u>10,000</u> *		<u>6,000</u> *	
	Sales	\$200,000	\$20	\$300,000 *	\$50
	Variable expenses	<u>70,000</u> *	<u>7</u>	<u>210,000</u>	<u>35</u>
	Contribution margin	130,000	<u>\$13</u> *	90,000	<u>\$15</u>
	Fixed expenses	<u>118,000</u>		<u>100,000</u> *	
	Net operating income (loss) ..	<u>\$ 12,000</u> *		<u>\$ (10,000)</u> *	

b.		<u>Case #1</u>		<u>Case #2</u>	
	Sales	\$500,000 *	100%	\$400,000 *	100%
	Variable expenses	<u>400,000</u>	<u>80%</u>	<u>260,000</u> *	<u>65%</u>
	Contribution margin	100,000	<u>20%</u> *	140,000	<u>35%</u>
	Fixed expenses	<u>93,000</u>		<u>100,000</u> *	
	Net operating income ..	<u>\$ 7,000</u> *		<u>\$ 40,000</u>	
		<u>Case #3</u>		<u>Case #4</u>	
	Sales	\$250,000	100%	\$600,000 *	100%
	Variable expenses	<u>100,000</u>	<u>40%</u>	<u>420,000</u> *	<u>70%</u>
	Contribution margin	150,000	<u>60%</u> *	180,000	<u>30%</u>
	Fixed expenses	<u>130,000</u> *		<u>185,000</u>	
	Net operating income (loss) ..	<u>\$ 20,000</u> *		<u>\$ (5,000)</u> *	

*Given

Exercise 6-12 (30 minutes)

1.

	<u>Flight Dynamic</u>		<u>Sure Shot</u>		<u>Total Company</u>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
Sales.....	\$150,000	100	\$250,000	100	\$400,000	100.0
Variable expenses	<u>30,000</u>	<u>20</u>	<u>160,000</u>	<u>64</u>	<u>190,000</u>	<u>47.5</u>
Contribution margin.....	<u>\$120,000</u>	<u>80</u>	<u>\$ 90,000</u>	<u>36</u>	210,000	<u>52.5*</u>
Fixed expenses					<u>183,750</u>	
Net operating income					<u>\$ 26,250</u>	

*\$210,000 ÷ \$400,000 = 52.5%

2. The break-even point for the company as a whole is:

3. The additional contribution margin from the additional sales is computed as follows:

$\$100,000 \times 52.5\% \text{ CM ratio} = \$52,500$

Assuming no change in fixed expenses, all of this additional contribution margin of \$52,500 should drop to the bottom line as increased net operating income.

This answer assumes no change in selling prices, variable costs per unit, fixed expense, or sales mix.

Exercise 6-13 (20 minutes)

	<i>Total</i>	<i>Per Unit</i>
1. Sales (20,000 units × 1.15 = 23,000 units)	\$345,000	\$ 15.00
Variable expenses.....	<u>207,000</u>	<u>9.00</u>
Contribution margin.....	138,000	<u>\$ 6.00</u>
Fixed expenses	<u>70,000</u>	
Net operating income	<u>\$ 68,000</u>	
2. Sales (20,000 units × 1.25 = 25,000 units)	\$337,500	\$13.50
Variable expenses.....	<u>225,000</u>	<u>9.00</u>
Contribution margin.....	112,500	<u>\$ 4.50</u>
Fixed expenses	<u>70,000</u>	
Net operating income	<u>\$ 42,500</u>	
3. Sales (20,000 units × 0.95 = 19,000 units)	\$313,500	\$16.50
Variable expenses.....	<u>171,000</u>	<u>9.00</u>
Contribution margin.....	142,500	<u>\$ 7.50</u>
Fixed expenses	<u>90,000</u>	
Net operating income	<u>\$ 52,500</u>	
4. Sales (20,000 units × 0.90 = 18,000 units)	\$302,400	\$16.80
Variable expenses.....	<u>172,800</u>	<u>9.60</u>
Contribution margin.....	129,600	<u>\$ 7.20</u>
Fixed expenses	<u>70,000</u>	
Net operating income	<u>\$ 59,600</u>	

Exercise 6-14 (30 minutes)

1. Variable expenses: $\$40 \times (100\% - 30\%) = \28
2. The break-even points in unit sales (Q) and dollar sales are computed as follows:

Selling price	\$40	100%
Variable expenses.....	<u>28</u>	<u>70%</u>
Contribution margin.....	<u>\$12</u>	<u>30%</u>

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = \$12 \times Q - \$180,000$$

$$\$12Q = \$180,000$$

$$Q = \$180,000 \div \$12$$

$$Q = 15,000 \text{ units}$$

$$\text{In dollar sales: } 15,000 \text{ units} \times \$40 \text{ per unit} = \$600,000$$

Alternative solution:

$$\text{Profit} = \text{CM ratio} \times \text{Sales} - \text{Fixed expenses}$$

$$\$0 = 0.30 \times \text{Sales} - \$180,000$$

$$0.30 \times \text{Sales} = \$180,000$$

$$\text{Sales} = \$180,000 \div 0.30$$

$$\text{Sales} = \$600,000$$

$$\text{In unit sales: } \$600,000 \div \$40 \text{ per unit} = 15,000 \text{ units}$$

3. The unit sales and dollar sales needed to attain the target profit are computed as follows:

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$60,000 = \$12 \times Q - \$180,000$$

$$\$12Q = \$60,000 + \$180,000$$

$$\$12Q = \$240,000$$

$$Q = \$240,000 \div \$12$$

$$Q = 20,000 \text{ units}$$

$$\text{In dollar sales: } 20,000 \text{ units} \times \$40 \text{ per unit} = \$800,000$$

Exercise 6-14 (continued)

Alternative solution:

$$\begin{aligned}\text{Profit} &= \text{CM ratio} \times \text{Sales} - \text{Fixed expenses} \\ \$60,000 &= 0.30 \times \text{Sales} - \$180,000 \\ 0.30 \times \text{Sales} &= \$240,000 \\ \text{Sales} &= \$240,000 \div 0.30 \\ \text{Sales} &= \$800,000\end{aligned}$$

$$\text{In unit sales: } \$800,000 \div \$40 \text{ per unit} = 20,000 \text{ units}$$

4. The new break-even points in unit sales and dollar sales are computed as follows:

The company's new cost/revenue relation will be:

Selling price.....	\$40	100%
Variable expenses (\$28 - \$4).....	<u>24</u>	<u>60%</u>
Contribution margin	<u>\$16</u>	<u>40%</u>

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$0 &= (\$40 - \$24) \times Q - \$180,000 \\ \$16Q &= \$180,000 \\ Q &= \$180,000 \div \$16 \text{ per unit} \\ Q &= 11,250 \text{ units}\end{aligned}$$

$$\text{In dollar sales: } 11,250 \text{ units} \times \$40 \text{ per unit} = \$450,000$$

Alternative solution:

$$\begin{aligned}\text{Profit} &= \text{CM ratio} \times \text{Sales} - \text{Fixed expenses} \\ \$0 &= 0.40 \times \text{Sales} - \$180,000 \\ 0.40 \times \text{Sales} &= \$180,000 \\ \text{Sales} &= \$180,000 \div 0.40 \\ \text{Sales} &= \$450,000\end{aligned}$$

$$\text{In unit sales: } \$450,000 \div \$40 \text{ per unit} = 11,250 \text{ units}$$

Exercise 6-14 (continued)

4. The dollar sales required to attain the target profit is computed as follows:

$$\begin{aligned}\text{Profit} &= \text{CM ratio} \times \text{Sales} - \text{Fixed expenses} \\ \$60,000 &= 0.40 \times \text{Sales} - \$180,000 \\ 0.40 \times \text{Sales} &= \$240,000 \\ \text{Sales} &= \$240,000 \div 0.40 \\ \text{Sales} &= \$600,000\end{aligned}$$

Exercise 6-15 (15 minutes)

1.

	<i>Total</i>	<i>Per Unit</i>
Sales (15,000 games)	\$300,000	\$20
Variable expenses	<u>90,000</u>	<u>6</u>
Contribution margin	210,000	<u>\$14</u>
Fixed expenses	<u>182,000</u>	
Net operating income	<u>\$ 28,000</u>	

The degree of operating leverage is:

$$\begin{aligned} \text{Degree of operating leverage} &= \frac{\text{Contribution margin}}{\text{Net operating income}} \\ &= \frac{\$210,000}{\$28,000} = 7.5 \end{aligned}$$

2. a. Sales of 18,000 games represent a 20% increase over last year's sales. Because the degree of operating leverage is 7.5, net operating income should increase by 7.5 times as much, or by 150% (7.5 × 20%).

b. The expected total dollar amount of net operating income for next year would be:

Last year's net operating income	\$28,000
Expected increase in net operating income next year (150% × \$28,000)	<u>42,000</u>
Total expected net operating income	<u>\$70,000</u>

Exercise 6-16 (30 minutes)

1. The contribution margin per person would be:

Price per ticket		\$35
Variable expenses:		
Dinner.....	\$18	
Favors and program	<u> 2</u>	<u> 20</u>
Contribution margin per person.....		<u>\$15</u>

The fixed expenses of the dinner-dance total \$6,000 (= \$2,800 + \$900 + \$1,000 + \$1,300). The break-even point would be:

$$\begin{aligned} \text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$0 &= (\$35 - \$20) \times Q - \$6,000 \\ \$0 &= (\$15) \times Q - \$6,000 \\ \$15Q &= \$6,000 \\ Q &= \$6,000 \div \$15 \\ Q &= 400 \text{ persons; or, at } \$35 \text{ per person, } \$14,000 \end{aligned}$$

Alternative solution:

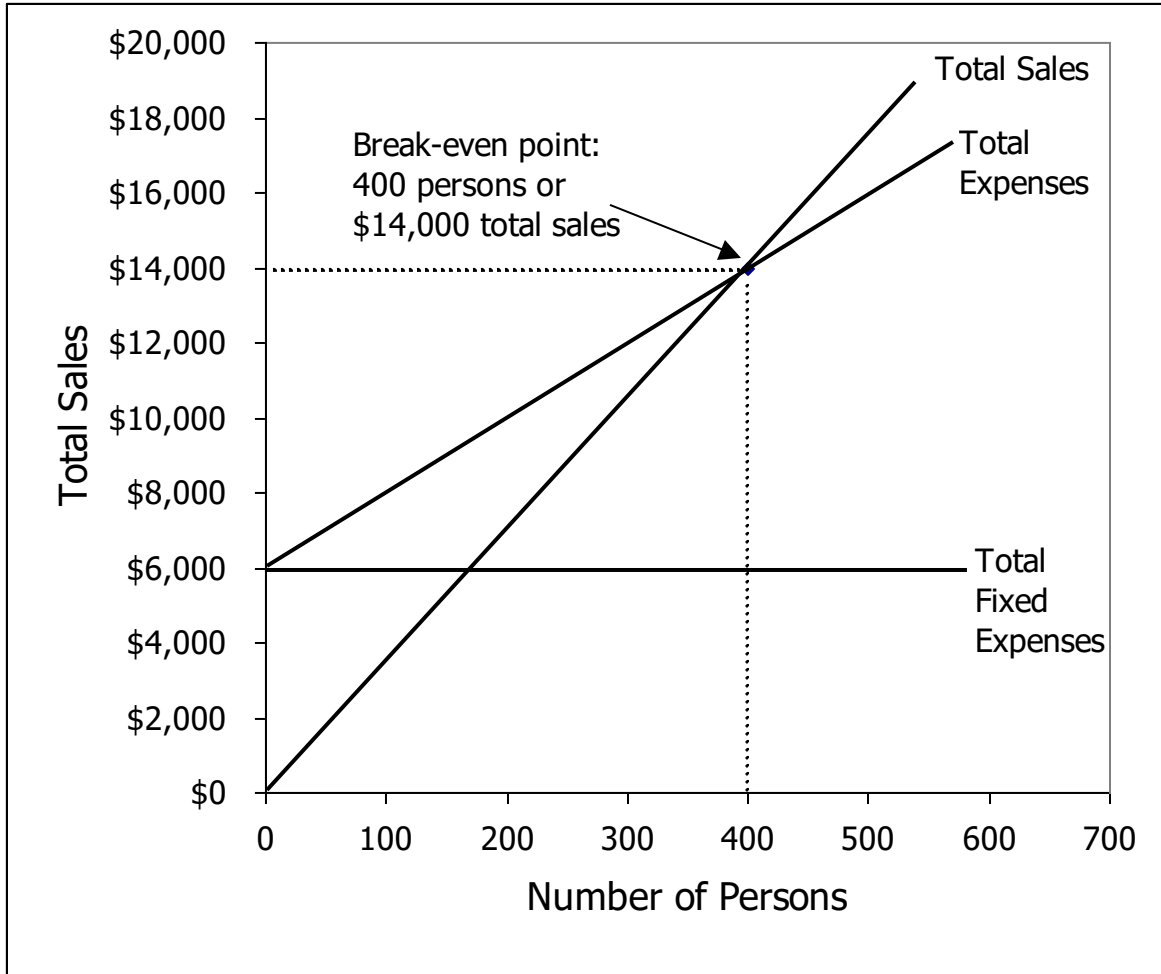
$$\begin{aligned} \text{Unit sales to} &= \frac{\text{Fixed expenses}}{\text{Unit contribution margin}} \\ \text{break even} &= \frac{\$6,000}{\$15} = 400 \text{ persons} \end{aligned}$$

or, at \$35 per person, \$14,000.

2. Variable cost per person (\$18 + \$2).....	\$20
Fixed cost per person (\$6,000 ÷ 300 persons) .	<u> 20</u>
Ticket price per person to break even.....	<u>\$40</u>

Exercise 6-16 (continued)

3. Cost-volume-profit graph:



Exercise 6-17 (30 minutes)

1. Profit = Unit CM × Q – Fixed expenses
 $\$0 = (\$50 - \$32) \times Q - \$108,000$
 $\$0 = (\$18) \times Q - \$108,000$
 $\$18Q = \$108,000$
 $Q = \$108,000 \div \18
 $Q = 6,000$ stoves, or at \$50 per stove, \$300,000 in sales

Alternative solution:

or at \$50 per stove, \$300,000 in sales.

2. An increase in variable expenses as a percentage of the selling price would result in a higher break-even point. If variable expenses increase as a percentage of sales, then the contribution margin will decrease as a percentage of sales. With a lower CM ratio, more stoves would have to be sold to generate enough contribution margin to cover the fixed costs.

3.	<i>Present:</i> <i>8,000 Stoves</i>		<i>Proposed:</i> <i>10,000 Stoves*</i>		
	<i>Total</i>	<i>Per Unit</i>	<i>Total</i>	<i>Per Unit</i>	
Sales	\$400,000	\$50	\$450,000	\$45	**
Variable expenses	<u>256,000</u>	<u>32</u>	<u>320,000</u>	<u>32</u>	
Contribution margin	144,000	<u>\$18</u>	130,000	<u>\$13</u>	
Fixed expenses	<u>108,000</u>		<u>108,000</u>		
Net operating income	<u>\$ 36,000</u>		<u>\$ 22,000</u>		

*8,000 stoves × 1.25 = 10,000 stoves

**\$50 × 0.9 = \$45

As shown above, a 25% increase in volume is not enough to offset a 10% reduction in the selling price; thus, net operating income decreases.

Exercise 6-17 (continued)

4. Profit = Unit CM × Q – Fixed expenses
\$35,000 = (\$45 – \$32) × Q – \$108,000
\$35,000 = (\$13) × Q – \$108,000
\$13 × Q = \$143,000
Q = \$143,000 ÷ \$13
Q = 11,000 stoves

Alternative solution:

$$\begin{aligned} \text{Unit sales to attain} &= \frac{\text{Target profit} + \text{Fixed expenses}}{\text{Unit contribution margin}} \\ \text{target profit} &= \frac{\$35,000 + \$108,000}{\$13} \\ &= 11,000 \text{ stoves} \end{aligned}$$

Exercise 6-18 (30 minutes)

- Profit = Unit CM × Q – Fixed expenses
 $\$0 = (\$30 - \$12) \times Q - \$216,000$
 $\$0 = (\$18) \times Q - \$216,000$
 $\$18Q = \$216,000$
 $Q = \$216,000 \div \18
 $Q = 12,000$ units, or at \$30 per unit, \$360,000

Alternative solution:

$$\begin{aligned} \text{Unit sales to break even} &= \frac{\text{Fixed expenses}}{\text{Unit contribution margin}} \\ &= \frac{\$216,000}{\$18} = 12,000 \text{ units} \end{aligned}$$

or at \$30 per unit, \$360,000

- The contribution margin is \$216,000 because the contribution margin is equal to the fixed expenses at the break-even point.
- The unit sales to attain the target profit is computed as follows:

$$\begin{aligned} \text{Units sold to attain target profit} &= \frac{\text{Target profit} + \text{Fixed expenses}}{\text{Unit contribution margin}} \\ &= \frac{\$90,000 + \$216,000}{\$18} \\ &= 17,000 \text{ units} \end{aligned}$$

	<i>Total</i>	<i>Unit</i>
Sales (17,000 units × \$30 per unit).....	\$510,000	\$30
Variable expenses		
(17,000 units × \$12 per unit).....	<u>204,000</u>	<u>12</u>
Contribution margin.....	306,000	<u>\$18</u>
Fixed expenses	<u>216,000</u>	
Net operating income	<u>\$ 90,000</u>	

Exercise 6-18 (continued)

4. Margin of safety in dollar terms:

$$\begin{aligned} \text{Margin of safety} &= \text{Total sales} - \text{Break-even sales} \\ \text{in dollars} & \\ &= \$450,000 - \$360,000 = \$90,000 \end{aligned}$$

Margin of safety in percentage terms:

5. The CM ratio is 60% [= $(\$30 - \$12) \div \$30$].

Expected total contribution margin: ($\$500,000 \times 60\%$) ..	\$300,000
Present total contribution margin: ($\$450,000 \times 60\%$)	<u>270,000</u>
Increased contribution margin	<u>\$ 30,000</u>

Alternative solution:

$$\$50,000 \text{ incremental sales} \times 60\% \text{ CM ratio} = \$30,000$$

Given that the company's fixed expenses will not change, monthly net operating income will also increase by \$30,000.

Problem 6-19 (45 minutes)

1. Sales (15,000 units × \$70 per unit).....	\$1,050,000
Variable expenses (15,000 units × \$40 per unit)...	<u>600,000</u>
Contribution margin.....	450,000
Fixed expenses.....	<u>540,000</u>
Net operating loss	<u>\$ (90,000)</u>

2. Unit sales to break even = $\frac{\text{Fixed expenses}}{\text{Unit contribution margin}}$

$$= \frac{\$540,000}{\$70 \text{ per unit} - \$40 \text{ per unit}}$$
$$= 18,000 \text{ units}$$

$$18,000 \text{ units} \times \$70 \text{ per unit} = \$1,260,000 \text{ to break even}$$

3. See the next page.

4. At a selling price of \$58 per unit, the contribution margin is \$18 per unit. Therefore:

$$30,000 \text{ units} \times \$58 \text{ per unit} = \$1,740,000 \text{ to break even.}$$

This break-even point is different from the break-even point in part (2) because of the change in selling price. With the change in selling price, the unit contribution margin drops from \$30 to \$18, resulting in an increase in the break-even point.

Problem 6-19 (continued)

3.

<i>Unit Selling Price</i>	<i>Unit Variable Expense</i>	<i>Unit Contribution Margin</i>	<i>Volume (Units)</i>	<i>Total Contribution Margin</i>	<i>Fixed Expenses</i>	<i>Net operating income (loss)</i>
\$70	\$40	\$30	15,000	\$450,000	\$540,000	\$ (90,000)
\$68	\$40	\$28	20,000	\$560,000	\$540,000	\$ 20,000
\$66	\$40	\$26	25,000	\$650,000	\$540,000	\$110,000
\$64	\$40	\$24	30,000	\$720,000	\$540,000	\$180,000
\$62	\$40	\$22	35,000	\$770,000	\$540,000	\$230,000
\$60	\$40	\$20	40,000	\$800,000	\$540,000	\$260,000
\$58	\$40	\$18	45,000	\$810,000	\$540,000	\$270,000
\$56	\$40	\$16	50,000	\$800,000	\$540,000	\$260,000

The maximum profit is \$270,000. This level of profit can be earned by selling 45,000 units at a price of \$58 each.

Problem 6-20 (75 minutes)

1. a. Selling price	\$25	100%
Variable expenses.....	<u>15</u>	<u>60%</u>
Contribution margin.....	<u>\$10</u>	<u>40%</u>

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = \$10 \times Q - \$210,000$$

$$\$10Q = \$210,000$$

$$Q = \$210,000 \div \$10$$

$$Q = 21,000 \text{ balls}$$

Alternative solution:

b. The degree of operating leverage is:

$$\begin{aligned} \text{Degree of operating leverage} &= \frac{\text{Contribution margin}}{\text{Net operating income}} \\ &= \frac{\$300,000}{\$90,000} = 3.33 \text{ (rounded)} \end{aligned}$$

2. The new CM ratio will be:

Selling price	\$25	100%
Variable expenses.....	<u>18</u>	<u>72%</u>
Contribution margin	<u>\$7</u>	<u>28%</u>

The new break-even point will be:

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = \$7 \times Q - \$210,000$$

$$\$7Q = \$210,000$$

$$Q = \$210,000 \div \$7$$

$$Q = 30,000 \text{ balls}$$

Problem 6-20 (continued)

Alternative solution:

3. Profit = Unit CM × Q – Fixed expenses
\$90,000 = \$7 × Q – \$210,000
\$7Q = \$90,000 + \$210,000
Q = \$300,000 ÷ \$7
Q = 42,857 balls (rounded)

Alternative solution:

Thus, sales will have to increase by 12,857 balls (= 42,857 balls – 30,000 balls = 12,857 balls) to earn the same amount of net operating income as last year. The computations above and in part (2) show the dramatic effect that increases in variable costs can have on an organization. The effects on Northwood Company are summarized below:

	<i>Present</i>	<i>Expected</i>
Break-even point (in balls).....	21,000	30,000
Sales (in balls) needed to earn a \$90,000 profit..	30,000	42,857

Note that if variable costs do increase next year, then the company will just break even if it sells the same number of balls (30,000) as it did last year.

Problem 6-20 (continued)

4. The contribution margin ratio last year was 40%. If we let P equal the new selling price, then:

$$P = \$18 + 0.40P$$

$$0.60P = \$18$$

$$P = \$18 \div 0.60$$

$$P = \$30$$

To verify:

Selling price.....	\$30	100%
Variable expenses	<u>18</u>	<u>60%</u>
Contribution margin.....	<u>\$12</u>	<u>40%</u>

Therefore, to maintain a 40% CM ratio, a \$3 increase in variable costs would require a \$5 increase in the selling price.

5. The new CM ratio would be:

Selling price	\$25	100%
Variable expenses	<u>9*</u>	<u>36%</u>
Contribution margin	<u>\$16</u>	<u>64%</u>

$$*\$15 - (\$15 \times 40\%) = \$9$$

The new break-even point would be:

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = \$16 \times Q - (\$210,000 \times 2)$$

$$\$16Q = \$420,000$$

$$Q = \$420,000 \div \$16$$

$$Q = 26,250 \text{ balls}$$

Alternative solution:

$$\begin{aligned} \text{Unit sales to} &= \frac{\text{Fixed expenses}}{\text{Unit contribution margin}} \\ \text{break even} & \\ &= \frac{\$420,000}{\$16} = 26,250 \text{ balls} \end{aligned}$$

Although this new break-even point is greater than the company's present break-even point of 21,000 balls [see Part (1) above], it is less than the break-even point will be if the company does not automate and variable labor costs rise next year [see Part (2) above].

Problem 6-20 (continued)

6. a. Profit = Unit CM × Q – Fixed expenses
\$90,000 = \$16 × Q – \$420,000
\$16Q = \$90,000 + \$420,000
Q = \$510,000 ÷ \$16
Q = 31,875 balls

Alternative solution:

Thus, the company will have to sell 1,875 more balls (31,875 – 30,000 = 1,875) than now being sold to earn a profit of \$90,000 per year. However, this is still less than the 42,857 balls that would have to be sold to earn a \$90,000 profit if the plant is not automated and variable labor costs rise next year [see Part (3) above].

b. The contribution income statement would be:

Sales (30,000 balls × \$25 per ball)	\$750,000
Variable expenses (30,000 balls × \$9 per ball)	<u>270,000</u>
Contribution margin	480,000
Fixed expenses	<u>420,000</u>
Net operating income	<u>\$ 60,000</u>

$$\begin{aligned} \text{Degree of operating leverage} &= \frac{\text{Contribution margin}}{\text{Net operating income}} \\ &= \frac{\$480,000}{\$60,000} = 8 \end{aligned}$$

Problem 6-20 (continued)

- c. This problem illustrates the difficulty faced by some companies. When variable labor costs increase, it is often difficult to pass these cost increases along to customers in the form of higher prices. Thus, companies are forced to automate resulting in higher operating leverage, often a higher break-even point, and greater risk for the company.

There is no clear answer as to whether one should have been in favor of constructing the new plant.

Problem 6-21 (30 minutes)

1.

	<i>Product</i>						<i>Total</i>
	<i>White</i>		<i>Fragrant</i>		<i>Loonzain</i>		
Percentage of total sales	40%		24%		36%		100%
Sales	\$300,000	100%	\$180,000	100%	\$270,000	100%	\$750,000 100%
Variable expenses	<u>216,000</u>	<u>72%</u>	<u>36,000</u>	<u>20%</u>	<u>108,000</u>	<u>40%</u>	<u>360,000 48%</u>
Contribution margin ..	<u>\$ 84,000</u>	<u>28%</u>	<u>\$144,000</u>	<u>80%</u>	<u>\$162,000</u>	<u>60%</u>	<u>390,000 52% *</u>
Fixed expenses							<u>449,280</u>
Net operating income (loss)							\$ <u>(59,280)</u>

*\$390,000 ÷ \$750,000 = 52%

2. Break-even sales would be:

Problem 6-21 (continued)

3. Memo to the president:

Although the company met its sales budget of \$750,000 for the month, the mix of products changed substantially from that budgeted. This is the reason the budgeted net operating income was not met, and the reason the break-even sales were greater than budgeted. The company's sales mix was planned at 20% White, 52% Fragrant, and 28% Loonzain. The actual sales mix was 40% White, 24% Fragrant, and 36% Loonzain.

As shown by these data, sales shifted away from Fragrant Rice, which provides our greatest contribution per dollar of sales, and shifted toward White Rice, which provides our least contribution per dollar of sales. Although the company met its budgeted level of sales, these sales provided considerably less contribution margin than we had planned, with a resulting decrease in net operating income. Notice from the attached statements that the company's overall CM ratio was only 52%, as compared to a planned CM ratio of 64%. This also explains why the break-even point was higher than planned. With less average contribution margin per dollar of sales, a greater level of sales had to be achieved to provide sufficient contribution margin to cover fixed costs.

Problem 6-22 (60 minutes)

1. The CM ratio is 30%.

	<i>Total</i>	<i>Per Unit</i>	<i>Percent of Sales</i>
Sales (19,500 units)	\$585,000	\$30.00	100%
Variable expenses	<u>409,500</u>	<u>21.00</u>	<u>70%</u>
Contribution margin	<u>\$175,500</u>	<u>\$ 9.00</u>	<u>30%</u>

The break-even point is:

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = (\$30 - \$21) \times Q - \$180,000$$

$$\$0 = (\$9) \times Q - \$180,000$$

$$\$9Q = \$180,000$$

$$Q = \$180,000 \div \$9$$

$$Q = 20,000 \text{ units}$$

$$20,000 \text{ units} \times \$30 \text{ per unit} = \$600,000 \text{ in sales}$$

Alternative solution:

2. Incremental contribution margin:

\$80,000 increased sales \times 0.30 CM ratio	\$24,000
Less increased advertising cost	<u>16,000</u>
Increase in monthly net operating income	<u>\$ 8,000</u>

Since the company is now showing a loss of \$4,500 per month, if the changes are adopted, the loss will turn into a profit of \$3,500 each month ($\$8,000 - \$4,500 = \$3,500$).

Problem 6-22 (continued)

3. Sales (39,000 units @ \$27.00 per unit*)	\$1,053,000
Variable expenses (39,000 units @ \$21.00 per unit).....	<u>819,000</u>
Contribution margin.....	234,000
Fixed expenses (\$180,000 + \$60,000).....	<u>240,000</u>
Net operating loss	<u>\$ (6,000)</u>

$$*\$30.00 - (\$30.00 \times 0.10) = \$27.00$$

4. Profit = Unit CM \times Q – Fixed expenses
 $\$9,750 = (\$30.00 - \$21.75) \times Q - \$180,000$
 $\$9,750 = (\$8.25) \times Q - \$180,000$
 $\$8.25Q = \$189,750$
 $Q = \$189,750 \div \8.25
 $Q = 23,000$ units

$$*\$21.00 + \$0.75 = \$21.75$$

Alternative solution:

$$\begin{aligned} \text{Unit sales to attain target profit} &= \frac{\text{Target profit} + \text{Fixed expenses}}{\text{CM per unit}} \\ &= \frac{\$9,750 + \$180,000}{\$8.25^{**}} \\ &= 23,000 \text{ units} \end{aligned}$$

$$**\$30.00 - \$21.75 = \$8.25$$

5. a. The new CM ratio would be:

	<i>Per Unit</i>	<i>Percent of Sales</i>
Sales.....	\$30.00	100%
Variable expenses	<u>18.00</u>	<u>60%</u>
Contribution margin.....	<u>\$12.00</u>	<u>40%</u>

Problem 6-22 (continued)

The new break-even point would be:

$$\begin{aligned} \text{Unit sales to break even} &= \frac{\text{Fixed expenses}}{\text{Unit contribution margin}} \\ &= \frac{\$180,000 + \$72,000}{\$12.00} \\ &= 21,000 \text{ units} \end{aligned}$$

$$\begin{aligned} \text{Dollar sales to break even} &= \frac{\text{Fixed expenses}}{\text{CM ratio}} \\ &= \frac{\$180,000 + \$72,000}{0.40} \\ &= \$630,000 \end{aligned}$$

b. Comparative income statements follow:

	<i>Not Automated</i>			<i>Automated</i>		
	<i>Total</i>	<i>Per Unit</i>	<i>%</i>	<i>Total</i>	<i>Per Unit</i>	<i>%</i>
Sales (26,000 units).....	\$780,000	\$30.00	100	\$780,000	\$30.00	100
Variable expenses	<u>546,000</u>	<u>21.00</u>	<u>70</u>	<u>468,000</u>	<u>18.00</u>	<u>60</u>
Contribution margin.....	234,000	<u>\$ 9.00</u>	<u>30</u>	312,000	<u>\$12.00</u>	<u>40</u>
Fixed expenses ..	<u>180,000</u>			<u>252,000</u>		
Net operating income	<u>\$ 54,000</u>			<u>\$ 60,000</u>		

Problem 6-22 (continued)

- c. Whether or not the company should automate its operations depends on how much risk the company is willing to take and on prospects for future sales. The proposed changes would increase the company's fixed costs and its break-even point. However, the changes would also increase the company's CM ratio (from 0.30 to 0.40). The higher CM ratio means that once the break-even point is reached, profits will increase more rapidly than at present. If 26,000 units are sold next month, for example, the higher CM ratio will generate \$6,000 (= \$60,000 – \$54,000) more in profits than if no changes are made.

The greatest risk of automating is that future sales may drop back down to present levels (only 19,500 units per month), and as a result, losses will be even larger than at present due to the company's greater fixed costs. (Note the problem states that sales are erratic from month to month.) In sum, the proposed changes will help the company if sales continue to trend upward in future months; the changes will hurt the company if sales drop back down to or near present levels.

Note to the Instructor: Although it is not asked for in the problem, if time permits you may want to compute the point of indifference between the two alternatives in terms of units sold; i.e., the point where profits will be the same under either alternative. At this point, total revenue will be the same; hence, we include only costs in our equation:

$$\begin{aligned}\text{Let } Q &= \text{Point of indifference in units sold} \\ \$21.00Q + \$180,000 &= \$18.00Q + \$252,000 \\ \$3.00Q &= \$72,000 \\ Q &= \$72,000 \div \$3.00 \\ Q &= 24,000 \text{ units}\end{aligned}$$

If more than 24,000 units are sold in a month, the proposed plan will yield the greater profits; if less than 24,000 units are sold in a month, the present plan will yield the greater profits (or the least loss).

Problem 6-23 (60 minutes)

1. The CM ratio is 60%:

Sales price	\$20.00	100%
Variable expenses.....	<u>8.00</u>	<u>40%</u>
Contribution margin.....	<u>\$12.00</u>	<u>60%</u>

2.

3. \$75,000 increased sales \times 0.60 CM ratio = \$45,000 increased contribution margin. Because the fixed costs will not change, net operating income should also increase by \$45,000.

4a. The degree of operating leverage is calculated as follows:

4b. $4 \times 20\% = 80\%$ increase in net operating income. In dollars, this increase would be $80\% \times \$60,000 = \$48,000$.

Problem 6-23 (continued)

5. This year's net operating income is computed as follows:

Sales (25,000 units × \$18 per unit).....	\$450,000
Variable expenses (25,000 units × \$8 per unit) ..	<u>200,000</u>
Contribution margin.....	250,000
Fixed expenses (\$180,000 + \$30,000).....	<u>210,000</u>
Net operating income.....	<u>\$ 40,000</u>

The sales manager's suggestions should not be implemented because they will lower net operating income by \$20,000 (= \$60,000 – \$40,000).

6. Expected total contribution margin:

20,000 units × 1.25 × \$11.00 per unit*	\$275,000
Present total contribution margin	<u>240,000</u>
Incremental contribution margin, and the amount by which advertising can be increased with net operating income remaining unchanged	<u>\$ 35,000</u>

*\$20.00 – (\$8.00 + \$1.00) = \$11.00

Problem 6-24 (30 minutes)

The key to solving the requirements of this problem is understanding that the sweatshirts represent a step-fixed cost. They cannot be purchased at a cost of \$8 each. They must be bought in batches of 75 sweatshirts at a cost of \$600 per batch (75 sweatshirts × \$8 per shirt = \$600 per batch).

1. A good starting point for solving this problem is to compute the profit from buying and selling one batch of 75 sweatshirts:

Sales (75 shirts × \$13.50)	\$1,012.50
Variable expenses (75 shirts × \$1.50)	<u>112.50</u>
Contribution margin	900.00
Step-fixed expense (\$600 × 1 batch)	<u>600.00</u>
Net operating income	<u>\$ 300.00</u>

If the profit from selling one batch of 75 sweatshirts is \$300, then the profit from selling four batches of 75 sweatshirts, or 300 sweatshirts in total, will equal the target profit of \$1,200 (\$300 per batch × 4 batches = \$1,200).

Unit sales of 300 sweatshirts corresponds with dollar sales of \$4,050 (= 300 sweatshirts × \$13.50).

2. The contribution margin per sweatshirt is:

Selling price	\$13.50
Variable expenses	<u>1.50</u>
Contribution margin	<u>\$12.00</u>

The fixed cost associated with buying 75 sweatshirts is \$600; therefore, the break-even point would be 50 sweatshirts computed as follows:

$$\begin{aligned} \text{Unit sales to} &= \frac{\text{Fixed expenses}}{\text{Unit CM}} \\ \text{break even} &= \frac{\$600}{\$12.00} = 50 \text{ sweatshirts} \end{aligned}$$

50 sweatshirts × \$13.50 per sweatshirt = \$675 in total sales

Problem 6-24 (continued)

3. Purchasing four batches of sweatshirts, or a total of 300 sweatshirts, yields a profit of \$1,200. If Hooper purchased and sold five batches of sweatshirts, or a total of 375 sweatshirts, he would earn a profit of \$1,500 (\$1,200 + \$300). Since the target profit of \$1,320 is between \$1,200 and \$1,500, Hooper will need to attain a sales volume between 300 and 375 sweatshirts to achieve his target profit.

Given that the selling price per unit \$13.50, the variable cost per unit is \$1.50, the target profit is \$1,320, and the step-fixed cost in this scenario is \$3,000 (5 batches × \$600 per batch) The correct answer of 360 sweatshirts is calculated as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$1,320 &= (\$13.50 - \$1.50) \times Q - \$3,000 \\ \$1,320 &= (\$12) \times Q - \$3,000 \\ \$12Q &= \$4,320 \\ Q &= \$4,320 \div \$12 \\ Q &= 360 \text{ sweatshirts}\end{aligned}$$

Problem 6-25 (60 minutes)

1. The break-even point is calculated as follows:

$$\begin{aligned}\text{Profit} &= \text{Unit CM} \times Q - \text{Fixed expenses} \\ \$0 &= (\$3 - \$1) \times Q - \$22,000 \\ \$0 &= (\$2) \times Q - \$22,000 \\ \$2Q &= \$22,000 \\ Q &= \$22,000 \div \$2 \\ Q &= 11,000 \text{ units}\end{aligned}$$

2a. If Neptune produces and sells 18,000 units, it will earn net operating income of \$14,000, calculated as follows:

Sales (18,000 units × \$3.0)	\$54,000
Variable expenses (18,000 units × \$1.00) ..	<u>18,000</u>
Contribution margin	36,000
Fixed expenses.....	<u>22,000</u>
Net operating income.....	<u>\$14,000</u>

2b. If Neptune buys 18,000 units from its supplier and then resells them, it will earn net operating income of \$7,500, calculated as follows:

Sales (18,000 units × \$3.00)	\$54,000
Variable expenses (18,000 units × \$1.75) ..	<u>31,500</u>
Contribution margin	22,500
Fixed expenses.....	<u>15,000</u>
Net operating income.....	<u>\$ 7,500</u>

Problem 6-25 (continued)

3. In this scenario, the total fixed expenses are \$37,000 (\$22,000 + \$15,000), the contribution margin per unit for the first 18,000 units produced in-house is \$2.00 per unit, and the contribution margin per unit for each unit produced by the supplier is \$1.25 per unit. Thus, the break-even point of 18,800 units is computed as follows:

Fixed expenses (\$22,000 + \$15,000).....	\$37,000
Contribution margin from in-house production (18,000 units × \$2.00)	<u>36,000</u>
Contribution margin that must be earned on outsourced units to cover fixed expenses	<u>\$ 1,000</u>
Contribution margin that must be earned on outsourced units to cover fixed expenses (a)	\$1,000
Contribution margin per unit from supplier (b).	\$1.25
Unit sales needed from supplier to break-even (a) ÷ (b)	800

The total unit sales required to break-even is 18,000 units produced in-house plus 800 units provided by the supplier, or a total of 18,800 units.

- 4a. In this scenario, the total fixed expenses plus target profit is \$51,000 (\$22,000 + \$15,000 + \$14,000), the contribution margin per unit for the first 18,000 units produced in-house is \$2.00 per unit, and the contribution margin per unit for each unit produced by the supplier is \$1.25 per unit. Thus, the required unit sales is computed as follows:

Fixed expenses plus target profit (\$22,000 + \$15,000 + \$14,000)	\$51,000
Contribution margin from in-house production (18,000 units × \$2.00)	<u>36,000</u>
Contribution margin that must be realized on outsourced units to earn target profit.....	<u>\$15,000</u>

Problem 6-25 (continued)

Contribution margin that must be realized on outsourced units to earn target profit (a).....	\$15,000
Contribution margin per unit from supplier (b).	\$1.25
Unit sales needed from supplier to earn target profit (a) ÷ (b)	12,000

The total unit sales required to earn the target profit is 30,000 units, which includes 18,000 units produced in-house plus 12,000 units provided by the supplier.

- 4b. This scenario is identical to requirement 4a except the target profit changes from \$14,000 to \$16,500; hence, the required unit sales is calculated as follows:

Fixed expenses plus target profit (\$22,000 + \$15,000 + \$16,500)	\$53,500
Contribution margin from in-house production (18,000 units × \$2.00)	<u>36,000</u>
Contribution margin that must be realized on outsourced units to earn target profit.....	<u>\$17,500</u>

Contribution margin that must be realized on outsourced units to earn target profit (a).....	\$17,500
Contribution margin per unit from supplier (b).	\$1.25
Unit sales needed from supplier to earn target profit (a) ÷ (b)	14,000

The total unit sales required to earn the target profit is 32,000 units, which includes 18,000 units produced in-house plus 14,000 units provided by the supplier.

Problem 6-25 (continued)

4c. The net operating income is computed as follows:

Sales (35,000 units × \$3.00)	\$105,000
Variable expenses (18,000 units × \$1.00) + (17,000 units × \$1.75)	<u>47,750</u>
Contribution margin	57,250
Fixed expenses (\$22,000 + \$15,000)	<u>37,000</u>
Net operating income	<u>\$ 20,250</u>

4d. The net operating income is computed as follows:

Sales (35,000 units × \$3.00)	\$105,000
Variable expenses (18,000 units × \$1.00) + (800 units × \$1.75) + (16,200 units × \$1.85)	<u>49,370</u>
Contribution margin	55,630
Fixed expenses (\$22,000 + \$15,000)	<u>37,000</u>
Net operating income	<u>\$ 18,630</u>

5. The net operating income is computed as follows:

Sales (35,000 units × \$3.00)	\$105,000
Variable expenses (35,000 units × \$1.75) ..	<u>61,250</u>
Contribution margin	43,750
Fixed expenses (\$15,000 × 2)	<u>30,000</u>
Net operating income	<u>\$ 13,750</u>

Problem 6-26 (60 minutes)

1. Profit = Unit CM × Q – Fixed expenses

$$\$0 = (\$30 - \$18) \times Q - \$150,000$$

$$\$0 = (\$12) \times Q - \$150,000$$

$$\$12Q = \$150,000$$

$$Q = \$150,000 \div \$12$$

$$Q = 12,500 \text{ pairs}$$

$$12,500 \text{ pairs} \times \$30 \text{ per pair} = \$375,000 \text{ in sales}$$

2. See the graph on the following page.

3. The simplest approach is:

Break-even sales.....	12,500 pairs
Actual sales	<u>12,000</u> pairs
Sales short of break-even.....	<u>500</u> pairs

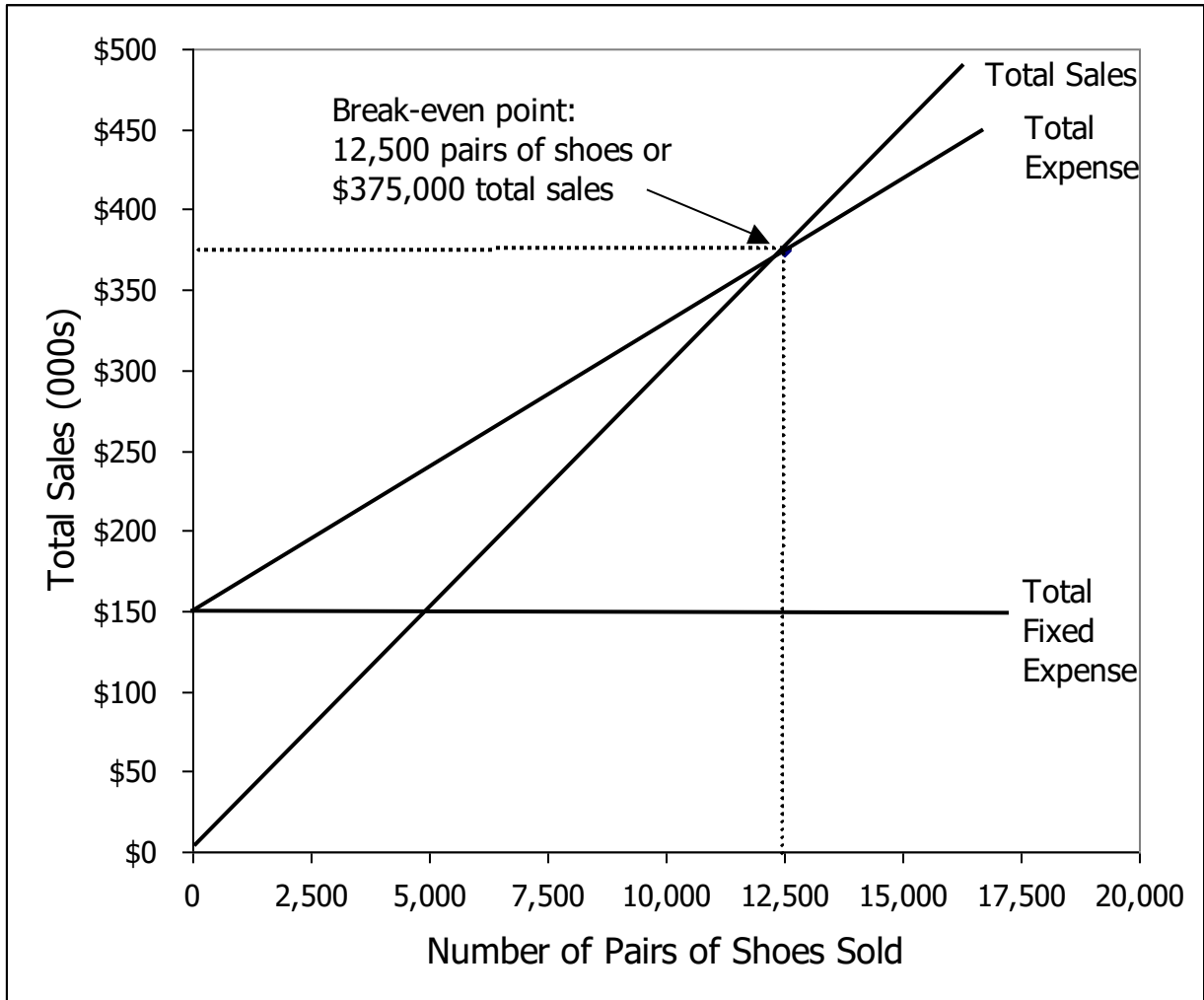
$$500 \text{ pairs} \times \$12 \text{ contribution margin per pair} = \$6,000 \text{ loss}$$

Alternative solution:

Sales (12,000 pairs × \$30.00 per pair)	\$360,000
Variable expenses	
(12,000 pairs × \$18.00 per pair)	<u>216,000</u>
Contribution margin.....	144,000
Fixed expenses	<u>150,000</u>
Net operating loss	<u>\$ (6,000)</u>

Problem 6-26 (continued)

2. Cost-volume-profit graph:



Problem 6-26 (continued)

4. The variable expenses will now be \$18.75 per pair, and the contribution margin will be \$11.25 per pair.

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = (\$30.00 - \$18.75) \times Q - \$150,000$$

$$\$0 = (\$11.25) \times Q - \$150,000$$

$$\$11.25Q = \$150,000$$

$$Q = \$150,000 \div \$11.25$$

$$Q = 13,333 \text{ pairs (rounded)}$$

$$13,333 \text{ pairs} \times \$30.00 \text{ per pair} = \$400,000 \text{ in sales}$$

Alternative solution:

5. The simplest approach is:

Actual sales 15,000 pairs

Break-even sales 12,500 pairs

Excess over break-even sales 2,500 pairs

$$2,500 \text{ pairs} \times \$11.50 \text{ per pair}^* = \$28,750 \text{ profit}$$

$$*\$12.00 \text{ present contribution margin} - \$0.50 \text{ commission} = \$11.50$$

Problem 6-26 (continued)

6. The new variable expenses will be \$13.50 per pair.

$$\text{Profit} = \text{Unit CM} \times Q - \text{Fixed expenses}$$

$$\$0 = (\$30.00 - \$13.50) \times Q - (\$150,000 + \$31,500)$$

$$\$0 = (\$16.50) \times Q - \$181,500$$

$$\$16.50Q = \$181,500$$

$$Q = \$181,500 \div \$16.50$$

$$Q = 11,000 \text{ pairs}$$

$$11,000 \text{ pairs} \times \$30.00 \text{ per pair} = \$330,000 \text{ in sales}$$

Although the change will lower the break-even point from 12,500 pairs to 11,000 pairs, the company must consider whether this reduction in the break-even point is more than offset by the possible loss in sales arising from having the sales staff on a salaried basis. Under a salary arrangement, the sales staff has less incentive to sell than under the present commission arrangement, resulting in a potential loss of sales and a reduction of profits. Although it is generally desirable to lower the break-even point, management must consider the other effects of a change in the cost structure. The break-even point could be reduced dramatically by doubling the selling price but it does not necessarily follow that this would improve the company's profit.

Problem 6-27 (45 minutes)

1. a.

	<i>Hawaiian Fantasy</i> (20,000 units)		<i>Tahitian Joy</i> (5,000 units)		<i>Total</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
Sales.....	\$300,000	100%	\$500,000	100%	\$800,000	100%
Variable expenses	<u>180,000</u>	<u>60%</u>	<u>100,000</u>	<u>20%</u>	<u>280,000</u>	<u>35%</u>
Contribution margin....	<u>\$120,000</u>	<u>40%</u>	<u>\$400,000</u>	<u>80%</u>	520,000	<u>65%</u>
Fixed expenses					<u>475,800</u>	
Net operating income .					<u>\$ 44,200</u>	

b. Dollar sales to break even = $\frac{\text{Fixed expenses}}{\text{CM ratio}} = \frac{\$475,800}{0.65} = \$732,000$

Problem 6-27 (continued)

2. a.	<i>Hawaiian Fantasy</i> (20,000 units)		<i>Tahitian Joy</i> (5,000 units)		<i>Samoan Delight</i> (10,000 units)		<i>Total</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
Sales	\$300,000	100%	\$500,000	100%	\$450,000	100%	\$1,250,000	100.0%
Variable expenses.....	<u>180,000</u>	<u>60%</u>	<u>100,000</u>	<u>20%</u>	<u>360,000</u>	<u>80%</u>	<u>640,000</u>	<u>51.2%</u>
Contribution margin	<u>\$120,000</u>	<u>40%</u>	<u>\$400,000</u>	<u>80%</u>	<u>\$ 90,000</u>	<u>20%</u>	610,000	<u>48.8%</u>
Fixed expenses...							<u>475,800</u>	
Net operating income.....							<u>\$ 134,200</u>	

Problem 6-27 (continued)

b.

3. The reason for the increase in the break-even point can be traced to the decrease in the company's overall contribution margin ratio when the third product is added. Note from the income statements above that this ratio drops from 65% to 48.8% with the addition of the third product. This product (the Samoan Delight) has a CM ratio of only 20%, which causes the average contribution margin per dollar of sales to shift downward.

This problem shows the somewhat tenuous nature of break-even analysis when the company has more than one product. The analyst must be very careful of his or her assumptions regarding sales mix, including the addition (or deletion) of new products.

It should be pointed out to the president that even though the break-even point is higher with the addition of the third product, the company's margin of safety is also greater. Notice that the margin of safety increases from \$68,000 to \$275,000 or from 8.5% to 22%. Thus, the addition of the new product shifts the company much further from its break-even point, even though the break-even point is higher.

Problem 6-28 (60 minutes)

1. April's Income Statement:

	<i>Standard</i>		<i>Deluxe</i>		<i>Pro</i>		<i>Total</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
Sales	\$80,000	100	\$60,000	100	\$450,000	100	\$590,000	100
Variable expenses:								
Production.....	44,000	55	27,000	45	157,500	35	228,500	38.7
Selling.....	<u>4,000</u>	<u>5</u>	<u>3,000</u>	<u>5</u>	<u>22,500</u>	<u>5</u>	<u>29,500</u>	<u>5.0</u>
Total variable expenses .	<u>48,000</u>	<u>60</u>	<u>30,000</u>	<u>50</u>	<u>180,000</u>	<u>40</u>	<u>258,000</u>	<u>43.7</u>
Contribution margin	<u>\$32,000</u>	<u>40</u>	<u>\$30,000</u>	<u>50</u>	<u>\$270,000</u>	<u>60</u>	<u>332,000</u>	<u>56.3</u>
Fixed expenses:								
Production.....							120,000	
Advertising							100,000	
Administrative.....							<u>50,000</u>	
Total fixed expenses							<u>270,000</u>	
Net operating income							<u>\$ 62,000</u>	

Problem 6-28 (continued)

May's Income Statement:

	<i>Standard</i>		<i>Deluxe</i>		<i>Pro</i>		<i>Total</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
Sales	\$320,000	100	\$60,000	100	\$270,000	100	\$650,000	100.0
Variable expenses:								
Production	176,000	55	27,000	45	94,500	35	297,500	45.8
Selling	<u>16,000</u>	<u>5</u>	<u>3,000</u>	<u>5</u>	<u>13,500</u>	<u>5</u>	<u>32,500</u>	<u>5.0</u>
Total variable expenses	<u>192,000</u>	<u>60</u>	<u>30,000</u>	<u>50</u>	<u>108,000</u>	<u>40</u>	<u>330,000</u>	<u>50.8</u>
Contribution margin	<u>\$128,000</u>	<u>40</u>	<u>\$30,000</u>	<u>50</u>	<u>\$162,000</u>	<u>60</u>	<u>320,000</u>	<u>49.2</u>
Fixed expenses:								
Production							120,000	
Advertising							100,000	
Administrative							<u>50,000</u>	
Total fixed expenses							<u>270,000</u>	
Net operating income							<u>\$ 50,000</u>	

Problem 6-28 (continued)

2. The sales mix has shifted over the last month from a greater concentration of Pro rackets to a greater concentration of Standard rackets. This shift has caused a decrease in the company's overall CM ratio from 56.3% in April to only 49.2% in May. For this reason, even though total sales (both in units and in dollars) is greater, net operating income is lower than last month in the division.

3. The break-even in dollar sales can be computed as follows:

$$\text{Dollar sales to break even} = \frac{\text{Fixed expenses}}{\text{CM ratio}} = \frac{\$270,000}{0.563} = \$479,574 \text{ (rounded)}$$

4. May's break-even point has gone up. The reason is that the division's overall CM ratio has declined for May as stated in (2) above. Unchanged fixed expenses divided by a lower overall CM ratio would yield a higher break-even point in sales dollars.

5.		<i>Standard</i>	<i>Pro</i>
	Increase in sales	\$20,000	\$20,000
	Multiply by the CM ratio	<u>× 40%</u>	<u>× 60%</u>
	Increase in net operating income*	<u>\$ 8,000</u>	<u>\$12,000</u>

*Assuming that fixed costs do not change.

Problem 6-29 (60 minutes)

1. The income statements would be:

	<i>Present</i>		
	<i>Amount</i>	<i>Per Unit</i>	<i>%</i>
Sales.....	\$450,000	\$30	100%
Variable expenses	<u>315,000</u>	<u>21</u>	<u>70%</u>
Contribution margin....	135,000	<u>\$ 9</u>	<u>30%</u>
Fixed expenses	<u>90,000</u>		
Net operating income .	<u>\$ 45,000</u>		
	<i>Proposed</i>		
	<i>Amount</i>	<i>Per Unit</i>	<i>%</i>
Sales.....	\$450,000	\$30	100%
Variable expenses*	<u>180,000</u>	<u>12</u>	<u>40%</u>
Contribution margin....	270,000	<u>\$18</u>	<u>60%</u>
Fixed expenses	<u>225,000</u>		
Net operating income .	<u>\$ 45,000</u>		

*\$21 – \$9 = \$12

2. a. Degree of operating leverage:

Present:

Proposed:

Problem 6-29 (continued)

b. Dollar sales to break even:

Present:

Proposed:

c. Margin of safety:

Present:

Proposed:

Problem 6-29 (continued)

3. The major factor would be the sensitivity of the company's operations to cyclical movements in the economy. Because the new equipment will increase the CM ratio, in years of strong economic activity, the company will be better off with the new equipment. However, in economic recession, the company will be worse off with the new equipment. The fixed costs of the new equipment will cause losses to be deeper and sustained more quickly than at present. Thus, management must decide whether the potential for greater profits in good years is worth the risk of deeper losses in bad years.
4. No information is given in the problem concerning the new variable expenses or the new contribution margin ratio. Both of these items must be determined before the new break-even point can be computed. The computations are:

New variable expenses:

$$\begin{aligned} \text{Profit} &= (\text{Sales} - \text{Variable expenses}) - \text{Fixed expenses} \\ \$54,000^{**} &= (\$585,000^* - \text{Variable expenses}) - \$180,000 \\ \text{Variable expenses} &= \$585,000 - \$180,000 - \$54,000 \\ &= \$351,000 \end{aligned}$$

*New level of sales: $\$450,000 \times 1.30 = \$585,000$

**New level of net operating income: $\$45,000 \times 1.2 = \$54,000$

New CM ratio:

Sales	\$585,000	100%
Variable expenses	<u>351,000</u>	<u>60%</u>
Contribution margin	<u>\$234,000</u>	<u>40%</u>

With the above data, the new break-even point can be computed:

Problem 6-29 (continued)

The greatest risk is that the increases in sales and net operating income predicted by the marketing manager will not happen and that sales will remain at their present level. Note that the present level of sales is \$450,000, which is equal to the break-even level of sales under the new marketing method. Thus, if the new marketing strategy is adopted and sales remain unchanged, profits will drop from the current level of \$45,000 per month to zero.

It would be a good idea to compare the new marketing strategy to the current situation more directly. What level of sales would be needed under the new method to generate at least the \$45,000 in profits the company is currently earning each month? The computations are:

Thus, sales would have to increase by at least 25% (\$562,500 is 25% higher than \$450,000) in order to make the company better off with the new marketing strategy than with the current situation. This appears to be extremely risky.

Problem 6-30 (60 minutes)

1. Profit = Unit CM × Q – Fixed expenses
$$\begin{aligned} \$0 &= (\$40 - \$16) \times Q - \$60,000 \\ \$0 &= (\$24) \times Q - \$60,000 \\ \$24Q &= \$60,000 \\ Q &= \$60,000 \div \$24 \\ Q &= 2,500 \text{ pairs, or at } \$40 \text{ per pair, } \$100,000 \text{ in sales} \end{aligned}$$

Alternative solution:

2. See the graphs at the end of this solution.

3. Profit = Unit CM × Q – Fixed expenses
$$\begin{aligned} \$18,000 &= \$24 \times Q - \$60,000 \\ \$24Q &= \$18,000 + \$60,000 \\ Q &= \$78,000 \div \$24 \\ Q &= 3,250 \text{ pairs} \end{aligned}$$

Alternative solution:

4. Incremental contribution margin:

\$25,000 increased sales × 60% CM ratio.....	\$15,000
Incremental fixed salary cost	<u>8,000</u>
Increased net income	<u>\$ 7,000</u>

Yes, the position should be converted to a full-time basis.

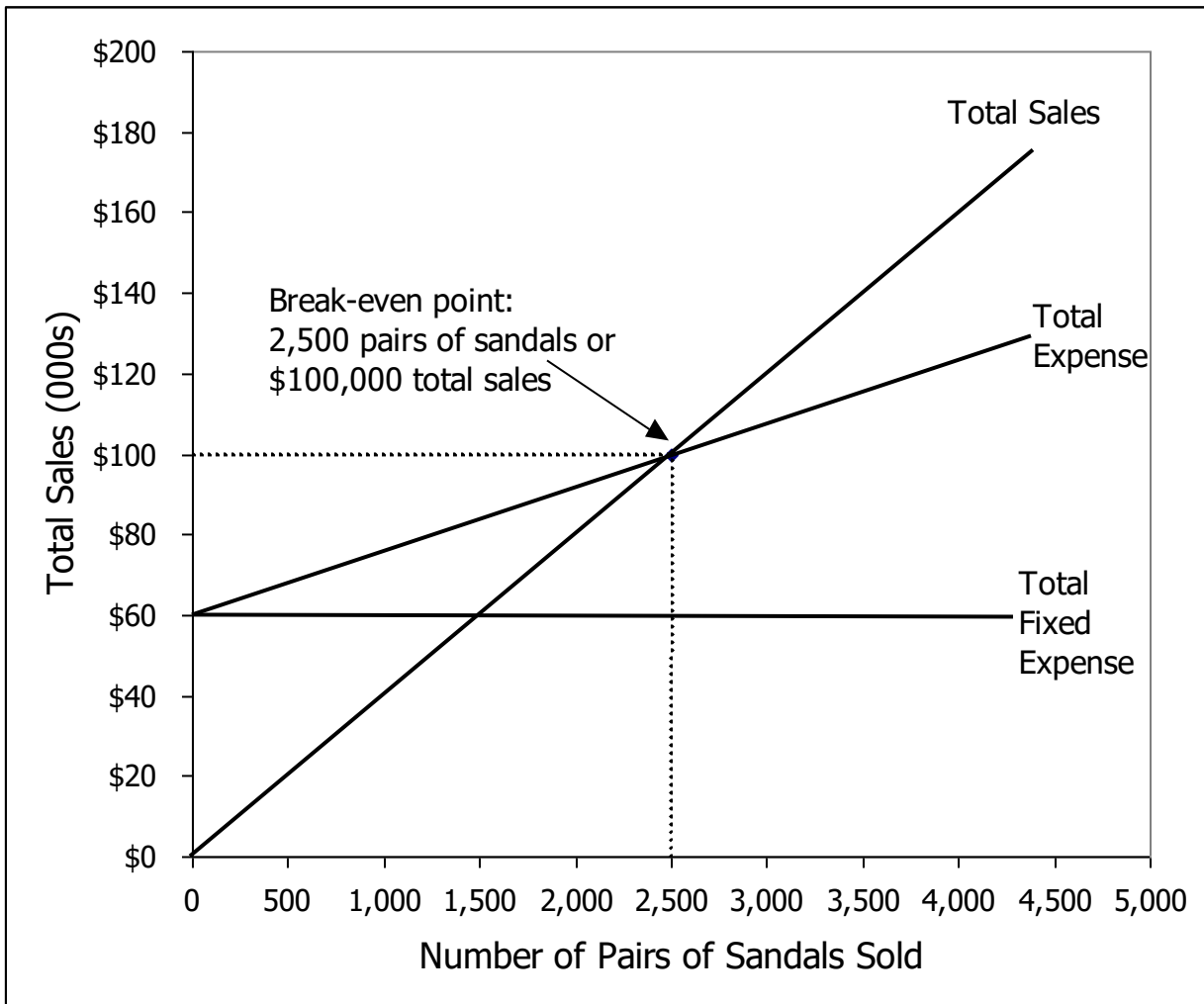
Problem 6-30 (continued)

5. a.

b. $6 \times 50\%$ sales increase = 300% *increase* in net operating income.

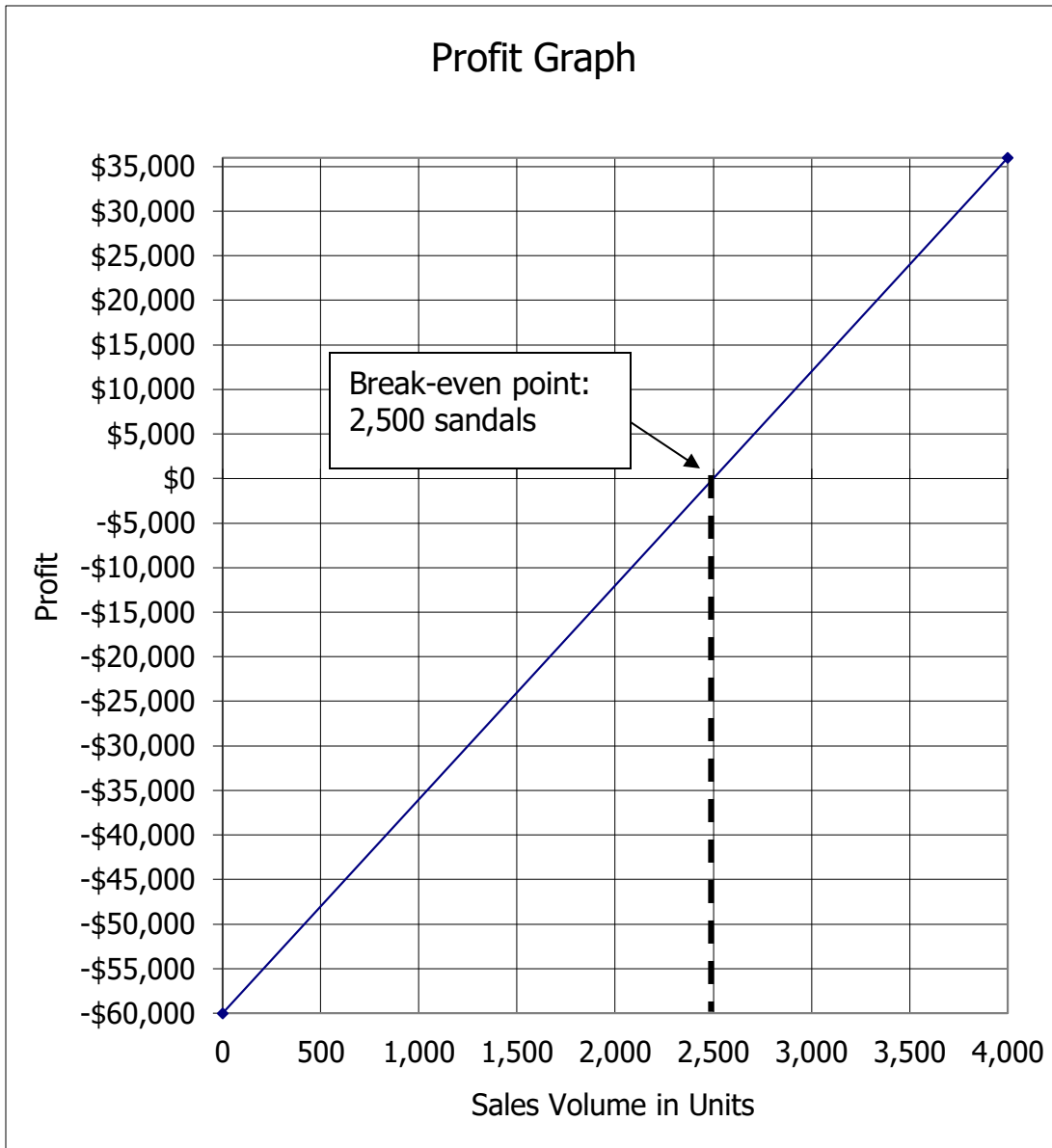
Thus, net operating income next year would be: $\$12,000 + (\$12,000 \times 300\%) = \$48,000$.

2. Cost-volume-profit graph:



Problem 6-30 (continued)

Profit graph:



Problem 6-31 (30 minutes)

1. (1) Dollars
- (2) Volume of output, expressed in units, % of capacity, sales, or some other measure
- (3) Total expense line
- (4) Variable expense area
- (5) Fixed expense area
- (6) Break-even point
- (7) Loss area
- (8) Profit area
- (9) Sales line

Problem 6-31 (continued)

2. a. Line 3: Remain unchanged.
Line 9: Have a steeper slope.
Break-even point: Decrease.
- b. Line 3: Have a flatter slope.
Line 9: Remain unchanged.
Break-even point: Decrease.
- c. Line 3: Shift upward.
Line 9: Remain unchanged.
Break-even point: Increase.
- d. Line 3: Remain unchanged.
Line 9: Remain unchanged.
Break-even point: Remain unchanged.
- e. Line 3: Shift downward and have a steeper slope.
Line 9: Remain unchanged.
Break-even point: Probably change, but the direction is uncertain.
- f. Line 3: Have a steeper slope.
Line 9: Have a steeper slope.
Break-even point: Remain unchanged in terms of units; increase in terms of total dollars of sales.
- g. Line 3: Shift upward.
Line 9: Remain unchanged.
Break-even point: Increase.
- h. Line 3: Shift upward and have a flatter slope.
Line 9: Remain unchanged.
Break-even point: Probably change, but the direction is uncertain.

Case (75 minutes)

Before proceeding with the solution, it is helpful first to restructure the data into contribution format for each of the three alternatives. (The data in the statements below are in thousands.)

	<u>15% Commission</u>		<u>20% Commission</u>		<u>Own Sales Force</u>	
Sales	\$16,000	100%	\$16,000	100%	\$16,000.00	100.0%
Variable expenses:						
Manufacturing	7,200		7,200		7,200.00	
Commissions (15%, 20%, 7.5%)	<u>2,400</u>		<u>3,200</u>		<u>1,200.00</u>	
Total variable expenses	<u>9,600</u>	<u>60%</u>	<u>10,400</u>	<u>65%</u>	<u>8,400.00</u>	<u>52.5%</u>
Contribution margin	<u>6,400</u>	<u>40%</u>	<u>5,600</u>	<u>35%</u>	<u>7,600.00</u>	<u>47.5%</u>
Fixed expenses:						
Manufacturing overhead	2,340		2,340		2,340.00	
Marketing	120		120		2,520.00 *	
Administrative	1,800		1,800		1,725.00 **	
Interest	<u>540</u>		<u>540</u>		<u>540.00</u>	
Total fixed expenses	<u>4,800</u>		<u>4,800</u>		<u>7,125.00</u>	
Income before income taxes	1,600		800		475.00	
Income taxes (30%)	<u>480</u>		<u>240</u>		<u>142.50</u>	
Net income	<u>\$ 1,120</u>		<u>\$ 560</u>		<u>\$ 332.50</u>	

*\$120,000 + \$2,400,000 = \$2,520,000

**\$1,800,000 – \$75,000 = \$1,725,000

Case (continued)

1. When the income before taxes is zero, income taxes will also be zero and net income will be zero. Therefore, the break-even calculations can be based on the income before taxes.
 - a. Break-even point in dollar sales if the commission remains 15%:

 - b. Break-even point in dollar sales if the commission increases to 20%:

 - c. Break-even point in dollar sales if the company employs its own sales force:

2. In order to generate a \$1,120,000 net income, the company must generate \$1,600,000 in income before taxes. Therefore,

3. To determine the volume of sales at which net income would be equal under either the 20% commission plan or the company sales force plan, we find the volume of sales where costs before income taxes under the two plans are equal. See the next page for the solution.

Case (continued)

$$\begin{aligned}
 X &= \text{Total sales revenue} \\
 0.65X + \$4,800,000 &= 0.525X + \$7,125,000 \\
 0.125X &= \$2,325,000 \\
 X &= \$2,325,000 \div 0.125 \\
 X &= \$18,600,000
 \end{aligned}$$

Thus, at a sales level of \$18,600,000 either plan would yield the same income before taxes and net income. Below this sales level, the commission plan would yield the largest net income; above this sales level, the sales force plan would yield the largest net income.

4. a., b., and c.

	<i>15%</i>	<i>20%</i>	<i>Own</i>
	<i>Commission</i>	<i>Commission</i>	<i>Sales Force</i>
Contribution margin (Part 1) (a).....	\$6,400,000	\$5,600,000	\$7,600,000
Income before taxes (Part 1) (b)....	\$1,600,000	\$800,000	\$475,000
Degree of operating leverage:			
(a) ÷ (b)	4	7	16

5. We would continue to use the sales agents for at least one more year, and possibly for two more years. The reasons are as follows:

First, use of the sales agents would have a less dramatic effect on net income.

Second, use of the sales agents for at least one more year would give the company more time to hire competent people and get the sales group organized.

Third, the sales force plan doesn't become more desirable than the use of sales agents until the company reaches sales of \$18,600,000 a year. This level probably won't be reached for at least one more year, and possibly two years.

Fourth, the sales force plan will be highly leveraged since it will increase fixed costs (and decrease variable costs). One or two years from now, when sales have reached the \$18,600,000 level, the company can benefit greatly from this leverage. For the moment, profits will be greater and risks will be less by staying with the agents, even at the higher 20% commission rate.

Teamwork in Action

1. The answer to this question will vary from school to school.
2. Managers will hire more support staff, such as security and vending personnel, for big games that predictably draw more people. These costs are variable with respect to the number of *expected* attendees, but are fixed with respect to the number of people who actually buy tickets. Most other costs are fixed with respect to both the number of expected and actual tickets sold—including the costs of the coaching staff, athletic scholarships, uniforms and equipment, facilities, and so on.
3. The answer to this question will vary from school to school, but a clear distinction should be drawn between the costs that are variable with respect to the number of tickets sold (i.e., actual attendees) versus the costs that are variable with respect to the expected number of tickets sold. The costs that are variable with respect to the number of tickets actually sold, given the number of expected tickets sold, are probably inconsequential since, as discussed above, staffing is largely decided based on expectations.
4. The answer to this question will vary from school to school. The lost profit is the difference between the ticket price and the variable cost of filling a seat multiplied by the number of unsold seats.
5. The answer to this question will vary from school to school.
6. The answer to this question will vary from school to school, but should be based on the answers to parts (4) and (5) above.

Appendix 6A

Analyzing Mixed Costs

Exercise 6A-1 (20 minutes)

1.	<i>Occupancy-</i>	<i>Electrical</i>
	<i>Days</i>	<i>Costs</i>
High activity level (August)..	2,406	\$5,148
Low activity level (October) .	<u>124</u>	<u>1,588</u>
Change	<u>2,282</u>	<u>\$3,560</u>

$$\begin{aligned} \text{Variable cost} &= \text{Change in cost} \div \text{Change in activity} \\ &= \$3,560 \div 2,282 \text{ occupancy-days} \\ &= \$1.56 \text{ per occupancy-day} \end{aligned}$$

Total cost (August)	\$5,148
Variable cost element	
(\$1.56 per occupancy-day × 2,406 occupancy-days) .	<u>3,753</u>
Fixed cost element	<u>\$1,395</u>

2. Electrical costs may reflect seasonal factors other than just the variation in occupancy days. For example, common areas such as the reception area must be lighted for longer periods during the winter than in the summer. This will result in seasonal fluctuations in the fixed electrical costs.

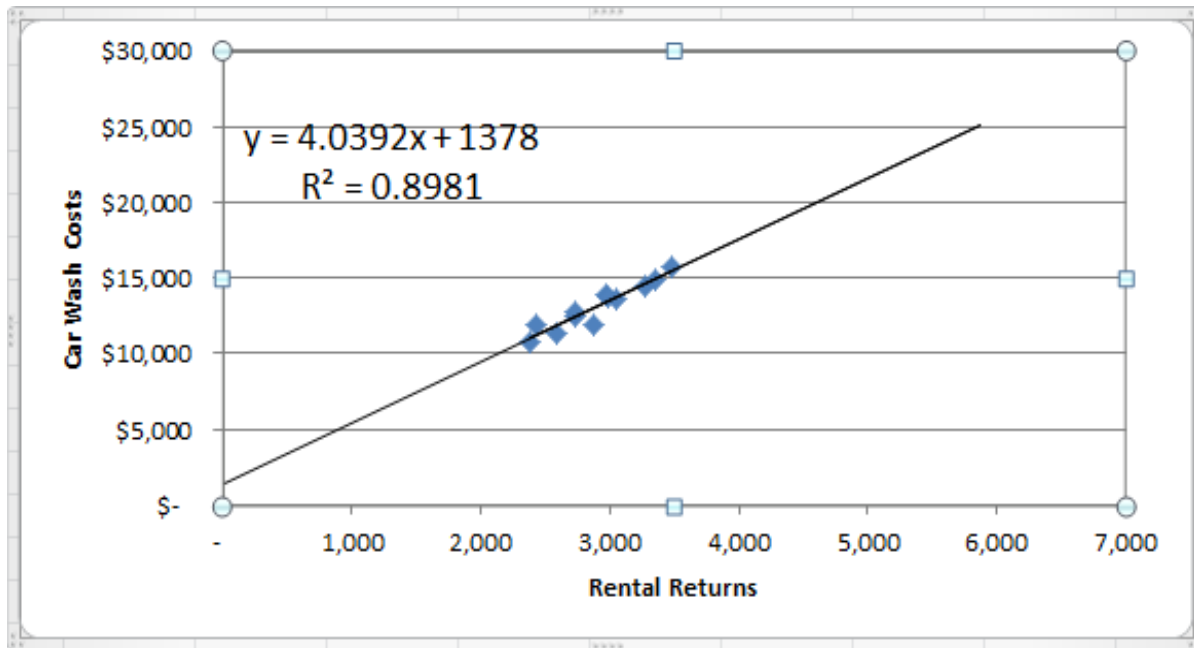
Additionally, fixed costs will be affected by the number of days in a month. In other words, costs like the costs of lighting common areas are variable with respect to the number of days in the month, but are fixed with respect to how many rooms are occupied during the month.

Other, less systematic, factors may also affect electrical costs such as the frugality of individual guests. Some guests will turn off lights when they leave a room. Others will not.

Exercise 6A-2 (20 minutes)

1. and 2.

The scattergraph plot and least-squares regression estimates of fixed and variable costs using Microsoft Excel are shown below:



The intercept provides the estimate of the fixed cost element, \$1,378 per month, and the slope provides the estimate of the variable cost element, \$4.04 per rental return. Expressed as an equation in the form $Y = a + bX$, the relation between car wash costs and rental returns is

$$Y = \$1,378 + \$4.04X$$

where X is the number of rental returns.

Note that the R^2 is approximately 0.90, which is quite high, and indicates a strong linear relationship between car wash costs and rental returns.

Exercise 6A-3 (20 minutes)

1.	<i>Kilometers Driven</i>	<i>Total Annual Cost*</i>
High level of activity	105,000	\$11,970
Low level of activity	<u>70,000</u>	<u>9,380</u>
Change	<u>35,000</u>	<u>\$ 2,590</u>

* 105,000 kilometers × \$0.114 per kilometer = \$11,970
 70,000 kilometers × \$0.134 per kilometer = \$9,380

Variable cost per kilometer:

$$\frac{\text{Change in cost}}{\text{Change in activity}} = \frac{\$2,590}{35,000 \text{ kilometers}} = \$0.074 \text{ per kilometer}$$

Fixed cost per year:

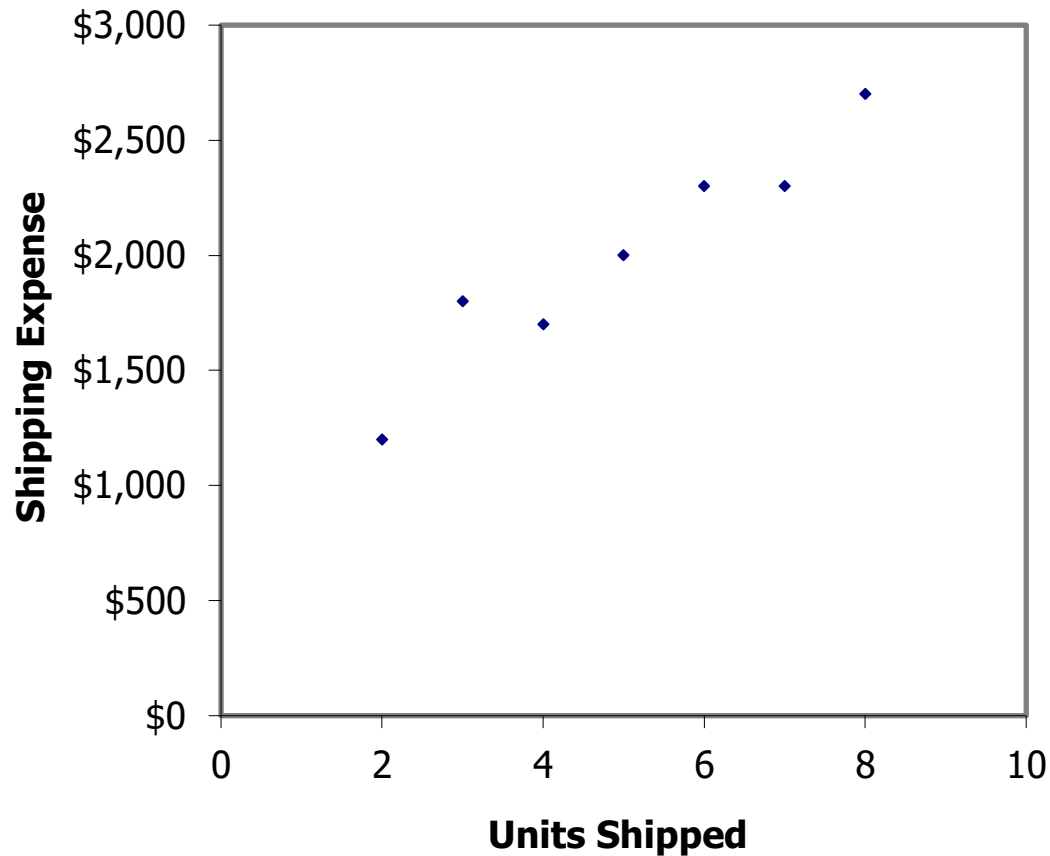
Total cost at 105,000 kilometers.....	\$11,970
Less variable portion:	
105,000 kilometers × \$0.074 per kilometer..	<u>7,770</u>
Fixed cost per year	<u>\$ 4,200</u>

2. $Y = \$4,200 + \$0.074X$

3. Fixed cost.....	\$ 4,200
Variable cost:	
80,000 kilometers × \$0.074 per kilometer	<u>5,920</u>
Total annual cost	<u>\$10,120</u>

Exercise 6A-4 (45 minutes)

1. The scattergraph appears below:



Yes, there is an approximately linear relationship between the number of units shipped and the total shipping expense.

Exercise 6A-4 (continued)

2. The high-low estimates and cost formula are computed as follows:

	<i>Units Shipped</i>	<i>Shipping Expense</i>
High activity level (June)	8	\$2,700
Low activity level (July)	<u>2</u>	<u>1,200</u>
Change	<u>6</u>	<u>\$1,500</u>

Variable cost element:

$$\frac{\text{Change in expense}}{\text{Change in activity}} = \frac{\$1,500}{6 \text{ units}} = \$250 \text{ per unit.}$$

Fixed cost element:

Shipping expense at high activity level	\$2,700
Less variable cost element (\$250 per unit × 8 units) ..	<u>2,000</u>
Total fixed cost	<u>\$ 700</u>

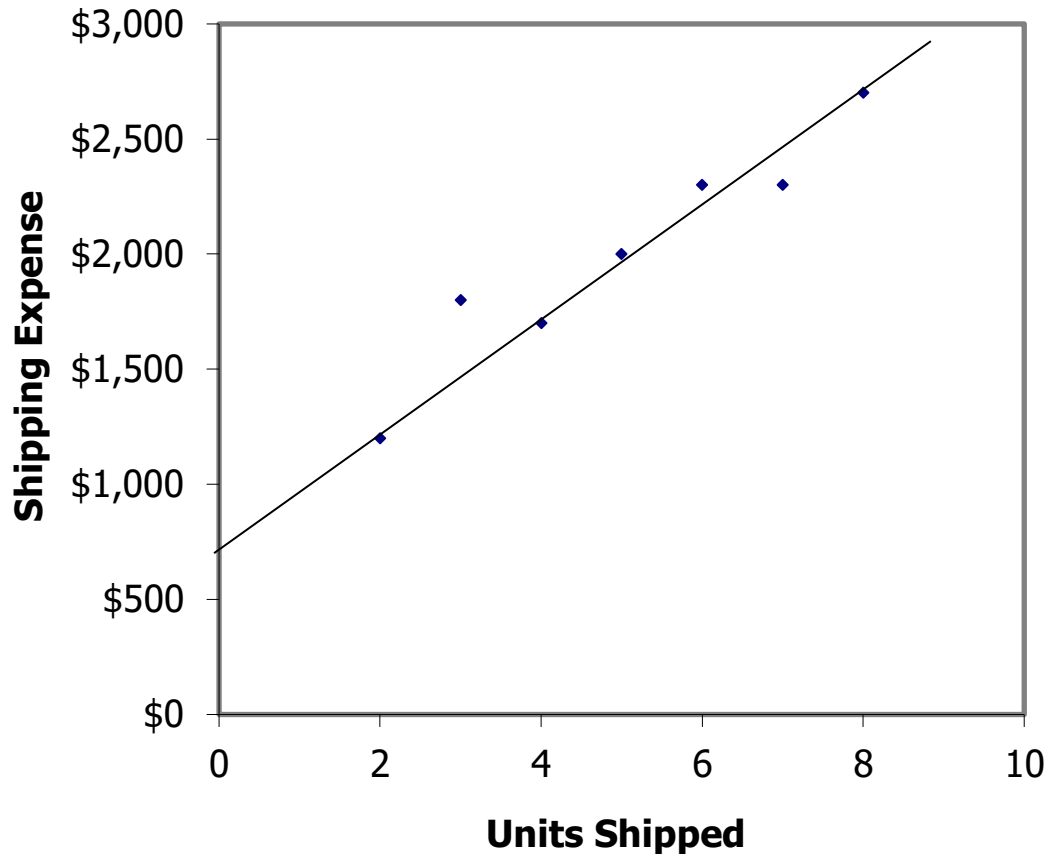
The cost formula is \$700 per month plus \$250 per unit shipped or

$$Y = \$700 + \$250X,$$

where X is the number of units shipped.

The scattergraph on the following page shows the straight line drawn through the high and low data points.

Exercise 6A-4 (continued)



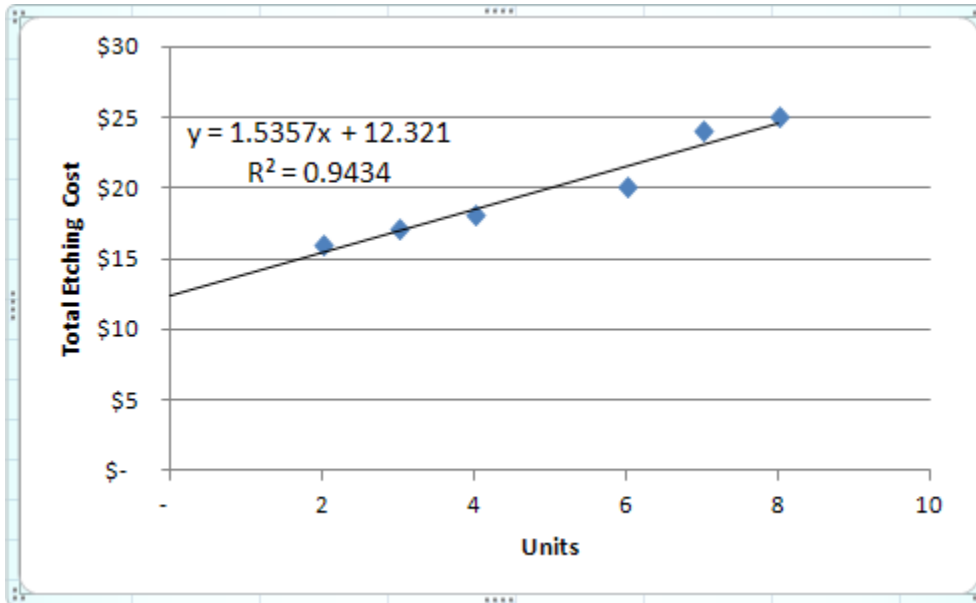
3. The high-low estimate of fixed costs is \$210.71 ($= \$910.71 - \700.00) lower than the estimate provided by least-squares regression. The high-low estimate of the variable cost per unit is \$32.14 ($= \$250.00 - \217.86) higher than the estimate provided by least-squares regression. A straight line that minimized the sum of the squared errors would intersect the Y-axis at \$910.71 instead of \$700. It would also have a flatter slope because the estimated variable cost per unit is lower than the high-low method.
4. The cost of shipping units is likely to depend on the weight and volume of the units shipped and the distance traveled as well as on the number of units shipped. In addition, higher cost shipping might be necessary to meet a deadline.

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Exercise 6A-5 (20 minutes)

1. and 2.

The scattergraph plot and regression estimates of fixed and variable costs using Microsoft Excel are shown below:



Note that the R^2 is approximately 0.94, which means that 94% of the variation in etching costs is explained by the number of units etched. This is a very high R^2 which indicates a very good fit.

The regression equation, in the form $Y = a + bX$, is as follows (where a is rounded to nearest dollar and b is rounded to the nearest cent):

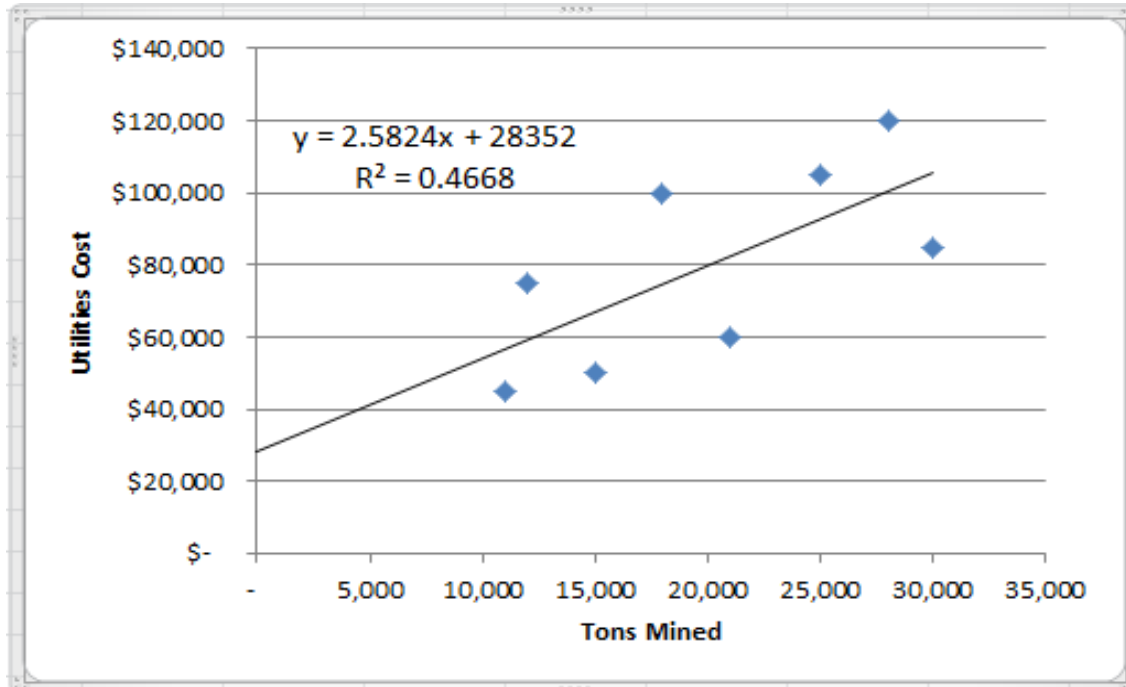
$$Y = \$12.32 + \$1.54X$$

3. Total expected etching cost if 5 units are processed:

Variable cost: 5 units \times \$1.54 per unit	\$ 7.70
Fixed cost	<u>12.32</u>
Total expected cost	<u>\$20.02</u>

Problem 6A-6 (30 minutes)

1. The scattergraph plot and regression estimates of fixed and variable costs using Microsoft Excel are shown below:



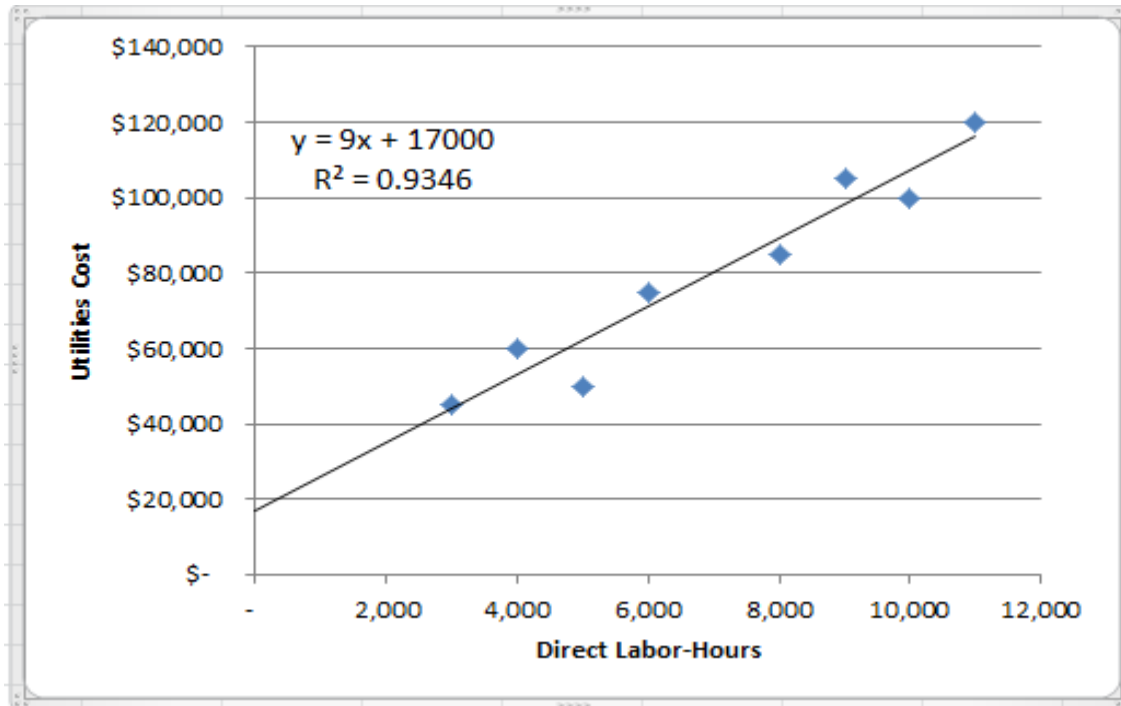
The cost formula, in the form $Y = a + bX$, using tons mined as the activity base is \$28,352 per quarter plus \$2.58 per ton mined, or

$$Y = \$28,352 + \$2.58X$$

Note that the R^2 is approximately 0.47, which means that only 47% of the variation in utility costs is explained by the number of tons mined.

Problem 6A-6 (continued)

- The scattergraph plot and regression estimates of fixed and variable costs using Microsoft Excel are shown below:



The cost formula, in the form $Y = a + bX$, using direct labor-hours as the activity base is \$17,000 per quarter plus \$9.00 per direct labor-hour, or:

$$Y = \$17,000 + \$9.00X$$

Note that the R^2 is approximately 0.93, which means that 93% of the variation in utility costs is explained by direct labor-hours. This is a very high R^2 which is an indication of a very good fit.

- The company should probably use direct labor-hours as the activity base, since the fit of the regression line to the data is much tighter than it is with tons mined. The R^2 for the regression using direct labor-hours as the activity base is twice as large as for the regression using tons mined as the activity base. However, managers should look more closely at the costs and try to determine why utilities costs are more closely tied to direct labor-hours than to the number of tons mined.

Problem 6A-7 (45 minutes)

1. Cost of goods sold Variable
- Advertising expense..... Fixed
- Shipping expense Mixed
- Salaries and commissions Mixed
- Insurance expense Fixed
- Depreciation expense..... Fixed

2. Analysis of the mixed expenses:

	<i>Units</i>	<i>Shipping Expense</i>	<i>Salaries and Commissions Expense</i>
High level of activity	5,000	\$38,000	\$90,000
Low level of activity	<u>4,000</u>	<u>34,000</u>	<u>78,000</u>
Change	<u>1,000</u>	<u>\$ 4,000</u>	<u>\$12,000</u>

Variable cost element:

$$\text{Variable rate} = \frac{\text{Change in cost}}{\text{Change in activity}}$$

$$\text{Shipping expense: } \frac{\$4,000}{1,000 \text{ units}} = \$4 \text{ per unit}$$

$$\text{Salaries and commissions expense: } \frac{\$12,000}{1,000 \text{ units}} = \$12 \text{ per unit}$$

Fixed cost element:

	<i>Shipping Expense</i>	<i>Salaries and Commissions Expense</i>
Cost at high level of activity ...	\$38,000	\$90,000
Less variable cost element:		
5,000 units × \$4 per unit	20,000	
5,000 units × \$12 per unit...		<u>60,000</u>
Fixed cost element	<u>\$18,000</u>	<u>\$30,000</u>

Problem 6A-7 (continued)

The cost formulas are:

Shipping expense:
\$18,000 per month plus \$4 per unit
or
 $Y = \$18,000 + \$4X$

Salaries and commissions expense:
\$30,000 per month plus \$12 per unit
or
 $Y = \$30,000 + \$12X$

3.

Morrisey & Brown, Ltd. Income Statement For the Month Ended September 30		
Sales (5,000 units × \$100 per unit).....		\$500,000
Variable expenses:		
Cost of goods sold		
(5,000 units × \$60 per unit)	\$300,000	
Shipping expense		
(5,000 units × \$4 per unit).....	20,000	
Salaries and commissions expense		
(5,000 units × \$12 per unit)	<u>60,000</u>	<u>380,000</u>
Contribution margin.....		120,000
Fixed expenses:		
Advertising expense	21,000	
Shipping expense.....	18,000	
Salaries and commissions expense.....	30,000	
Insurance expense	6,000	
Depreciation expense	<u>15,000</u>	<u>90,000</u>
Net operating income.....		<u>\$ 30,000</u>

Problem 6A-8 (20 minutes)

1. Maintenance cost at the 90,000 machine-hour level of activity can be isolated as follows:

	<i>Level of Activity</i>	
	<i>60,000 MHs</i>	<i>90,000 MHs</i>
Total factory overhead cost.....	\$174,000	\$246,000
Deduct:		
Utilities cost @ \$0.80 per MH*.	48,000	72,000
Supervisory salaries.....	<u>21,000</u>	<u>21,000</u>
Maintenance cost.....	<u>\$105,000</u>	<u>\$153,000</u>

*\$48,000 ÷ 60,000 MHs = \$0.80 per MH

2. High-low analysis of maintenance cost:

	<i>Machine- Hours</i>	<i>Maintenance Cost</i>
High activity level	90,000	\$153,000
Low activity level	<u>60,000</u>	<u>105,000</u>
Change.....	<u>30,000</u>	<u>\$ 48,000</u>

Variable rate:

$$\frac{\text{Change in cost}}{\text{Change in activity}} = \frac{\$48,000}{30,000 \text{ MHs}} = \$1.60 \text{ per MH}$$

Total fixed cost:

Total maintenance cost at the high activity level...	\$153,000
Less variable cost element	
(90,000 MHs × \$1.60 per MH).....	<u>144,000</u>
Fixed cost element.....	<u>\$ 9,000</u>

Therefore, the cost formula for maintenance is \$9,000 per month plus \$1.60 per machine-hour or

$$Y = \$9,000 + \$1.60X$$

Problem 6A-8 (continued)

	<i>Variable Cost per Machine-Hour</i>	<i>Fixed Cost</i>
3. Utilities cost	\$0.80	
Supervisory salaries cost .		\$21,000
Maintenance cost	<u>1.60</u>	<u>9,000</u>
Total overhead cost	<u>\$2.40</u>	<u>\$30,000</u>

Thus, the cost formula would be: $Y = \$30,000 + \$2.40X$.

4. Total overhead cost at an activity level of 75,000 machine-hours:

Fixed costs	\$ 30,000
Variable costs: 75,000 MHs × \$2.40 per MH.	<u>180,000</u>
Total overhead costs	<u>\$210,000</u>

Problem 6A-9 (30 minutes)

1. High-low method:

	<i>Units Sold</i>	<i>Shipping Expense</i>
High activity level	20,000	\$210,000
Low activity level	<u>10,000</u>	<u>119,000</u>
Change.....	<u>10,000</u>	<u>\$91,000</u>

$$\begin{aligned} \text{Variable cost per unit} &= \frac{\text{Change in cost}}{\text{Change in activity}} \\ &= \frac{\$91,000}{10,000 \text{ units}} = \$9.10 \text{ per unit} \end{aligned}$$

Fixed cost element:

Total shipping expense at high activity level	\$210,000
Less variable element:	
20,000 units × \$9.10 per unit.....	<u>182,000</u>
Fixed cost element.....	<u>\$ 28,000</u>

Therefore, the cost formula is: $Y = \$28,000 + \$9.10X$.

Problem 6A-9 (continued)

2.

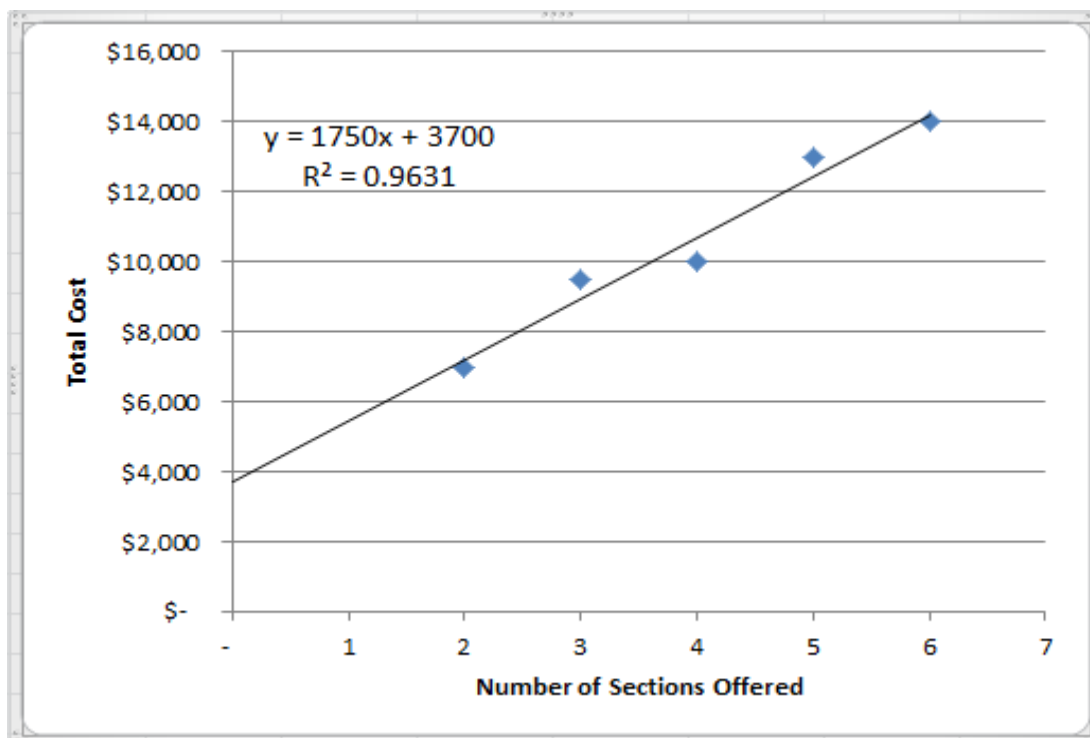
Milden Company
Budgeted Contribution Format Income Statement
For the First Quarter, Year 3

Sales (12,000 units × \$100 per unit)		\$1,200,000
Variable expenses:		
Cost of goods sold		
(12,000 units × \$35 unit)	\$420,000	
Sales commission (6% × \$1,200,000)	72,000	
Shipping expense		
(12,000 units × \$9.10 per unit)	<u>109,200</u>	
Total variable expenses		<u>601,200</u>
Contribution margin		598,800
Fixed expenses:		
Advertising expense	210,000	
Shipping expense	28,000	
Administrative salaries	145,000	
Insurance expense	9,000	
Depreciation expense	<u>76,000</u>	
Total fixed expenses		<u>468,000</u>
Net operating income		<u>\$ 130,800</u>

Problem 6A-10 (30 minutes)

1. and 2.

The scattergraph plot and regression estimates of fixed and variable costs using Microsoft Excel are shown below:



The cost formula, in the form $Y = a + bX$, using number of sections offered as the activity base is \$3,700 per quarter plus \$1,750 per section offered, or:

$$Y = \$3,700 + \$1,750X$$

Note that the R^2 is approximately 0.96, which means that 96% of the variation in cost is explained by the number of sections. This is a very high R^2 which indicates a very good fit.

Problem 6A-10 (continued)

3. Expected total cost would be:

Fixed cost	\$ 3,700
Variable cost (8 sections × \$1,750 per section).	<u>14,000</u>
Total cost.....	<u>\$17,700</u>

The problem with using the cost formula from (2) to derive total cost is that an activity level of 8 sections may lie outside the relevant range—the range of activity within which the fixed cost is approximately \$3,700 per term and the variable cost is approximately \$1,750 per section offered. These approximations appear to be reasonably accurate within the range of 2 to 6 sections, but they may be invalid outside this range.

Problem 6A-11 (60 minutes)

1. High-low method:

	<i>Hours</i>	<i>Cost</i>
High level of activity	25,000	\$99,000
Low level of activity	<u>10,000</u>	<u>64,500</u>
Change	<u>15,000</u>	<u>\$34,500</u>

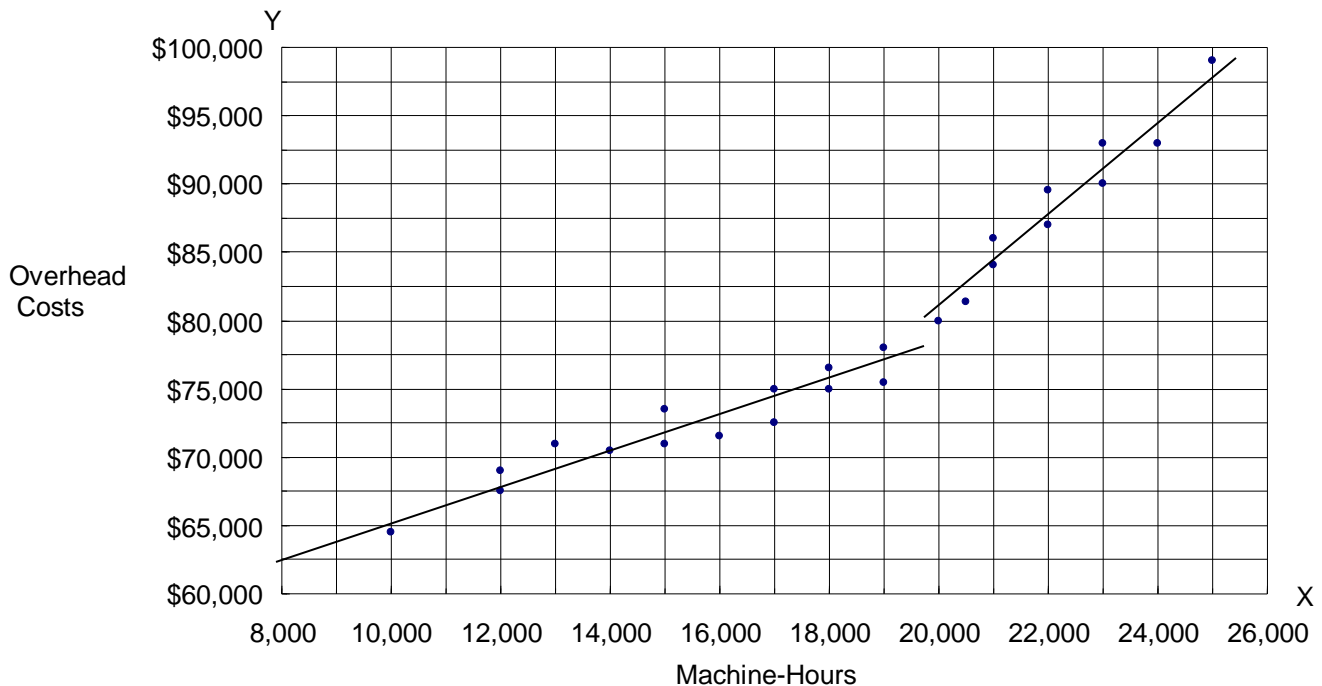
Variable element: $\$34,500 \div 15,000 \text{ DLH} = \2.30 per MH

Fixed element:

Total cost—25,000 MH	\$99,000
Less variable element:	
25,000 MH \times \$2.30 per MH	<u>57,500</u>
Fixed element	<u>\$41,500</u>

Therefore, the cost formula is: $Y = \$41,500 + \$2.30X$

2. The scattergraph is shown below:



Problem 6A-11 (continued)

2. The scattergraph shows that there are two relevant ranges—one below 19,500 MH and one above 19,500 MH. The change in equipment lease cost from a fixed fee to an hourly rate causes the slope of the regression line to be steeper above 19,500 MH, and to be discontinuous between the fixed fee and hourly rate points.
3. The cost formulas computed with the high-low and regression methods are faulty since they are based on the assumption that a single straight line provides the best fit to the data. Creating two data sets related to the two relevant ranges will enable more accurate cost estimates.

4. High-low method:

	<i>Hours</i>	<i>Cost</i>
High level of activity	25,000	\$99,000
Low level of activity	<u>20,000</u>	<u>80,000</u>
Change	<u>5,000</u>	<u>\$19,000</u>

Variable element: $\$19,000 \div 5,000 \text{ MH} = \3.80 per MH

Fixed element:

Total cost—25,000 MH	\$99,000
Less variable element:	
25,000 MH \times \$3.80 per MH	<u>95,000</u>
Fixed element	<u>\$4,000</u>

Expected overhead costs when 22,500 machine-hours are used:

Variable cost: 22,500 hours \times \$3.80 per hour	\$85,500
Fixed cost	<u>4,000</u>
Total cost	<u>\$89,500</u>

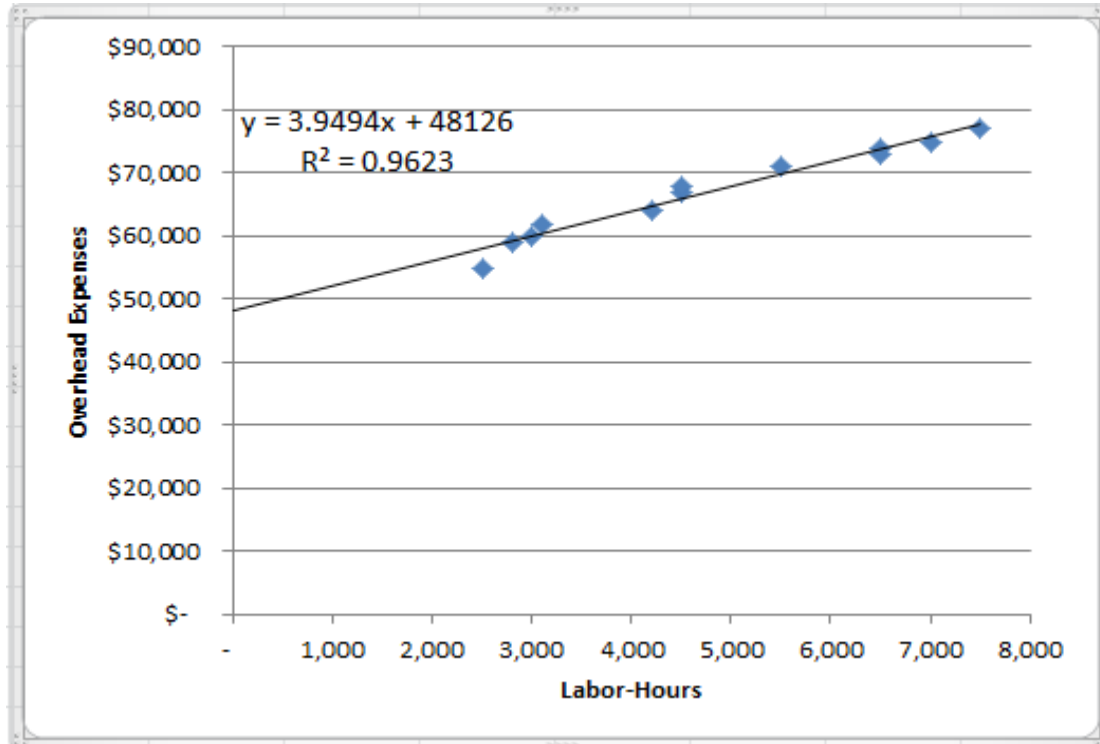
5. The high-low estimate of fixed costs is \$6,090 ($= \$10,090 - \$4,000$) lower than the estimate provided by least-squares regression. The high-low estimate of the variable cost per machine hour is \$0.27 ($= \$3.80 - \3.53) higher than the estimate provided by least-squares regression. A straight line that minimized the sum of the squared errors would intersect the Y-axis at \$10,090 instead of \$4,000. It would also have a

flatter slope because the estimated variable cost per unit is lower than the high-low method.

Problem 6A-12 (45 minutes)

1. and 2.

The scattergraph plot and regression estimates of fixed and variable costs using Microsoft Excel are shown below:



The scattergraph reveals three interesting findings. First, it indicates the relation between overhead expense and labor hours is approximated reasonably well by a straight line. (However, there appears to be a slight downward bend in the plot as the labor-hours increase—evidence of increasing returns to scale. This is a common occurrence in practice. See Noreen & Soderstrom, "Are overhead costs strictly proportional to activity?" *Journal of Accounting and Economics*, vol. 17, 1994, pp. 256-278.)

Second, the data points are all fairly close to the straight line. This indicates that most of the variation in overhead expenses is explained by labor hours. As a consequence, there probably wouldn't be much benefit to investigating other possible cost drivers for the overhead expenses.

Third, most of the overhead expense appears to be fixed. Maria should ask herself if this is reasonable. Does the company have large fixed expenses such as rent, depreciation, and salaries?

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Problem 6A-12 (continued)

The cost formula, in the form $Y = a + bX$, using labor-hours as the activity base is \$48,126 per month plus \$3.95 per labor-hour, or:

$$Y = \$48,126 + \$3.95X$$

Note that the R^2 is approximately 0.96, which means that 96% of the variation in cost is explained by labor-hours. This is a very high R^2 which indicates a very good fit.

3. Using the least-squares regression estimate of the variable overhead cost, the total variable cost per guest is computed as follows:

Food and beverages	\$15.00
Labor (0.5 hour @ \$10 per hour).....	5.00
Overhead (0.5 hour @ \$3.95 per hour) .	<u>1.98</u>
Total variable cost per guest.....	<u>\$21.98</u>

The total contribution from 180 guests paying \$31 each is computed as follows:

Sales (180 guests @ \$31.00 per guest)	\$5,580.00
Variable cost (180 guests @ \$21.98 per guest) ...	<u>3,956.40</u>
Contribution to profit	<u>\$1,623.60</u>

Fixed costs are not included in the above computation because there is no indication that any additional fixed costs would be incurred as a consequence of catering the cocktail party. If additional fixed costs were incurred, they should also be subtracted from revenue.

4. Assuming that no additional fixed costs are incurred as a result of catering the charity event, any price greater than the variable cost per guest of roughly \$22 would contribute to profits.

Problem 6A-12 (continued)

5. We would favor bidding slightly less than \$30 to get the contract. Any bid above \$22 would contribute to profits and a bid at the normal price of \$31 is unlikely to land the contract. And apart from the contribution to profit, catering the event would show off the company's capabilities to potential clients. The danger is that a price that is lower than the normal bid of \$31 might set a precedent for the future or it might initiate a price war among caterers. However, the price need not be publicized and the lower price could be justified to future clients because this is a charity event. Another possibility would be for Maria to maintain her normal price but throw in additional services at no cost to the customer. Whether to compete on price or service is a delicate issue that Maria will have to decide after getting to know the personality and preferences of the customer.