

Contribution margin and breakeven analysis

Business



Part A: While considering a large bulk order, Maria should use the concept of contribution margin in a way that the production volume of the product with higher contribution margin should not be cut off because it would possibly result in the overall loss of the total operating profit of the company. Let's discuss this point by taking the case of Maria's suggestion. At Aunt Connie's Cookies, two products are produced i. e. "Lemon Crme" and "Real Mint" cookies. When Maria received the bulk order offer for Real Mint, she decided to accept this offer by reducing the production of Lemon Crme because of its lower operating profit. This was the wrong decision because she did not consider the fact that despite lower operating profits, Lemon Crme enjoyed higher contribution margin than Real Mint i. e. 0.94 while Real Mint had the contribution margin of 0.64. The right decision should have been that the production of Lemon Crme should continue with the same quantity and its production should not be cut off. The bulk order should be accepted by reducing the current production of Real Mint.

There might be several circumstances where she should not accept the bulk order:

1. If the price offered for the Real Mint is low causing decline in the operating profit OR the price per unit offered can not offset the variable and fixed cost incurred on the production. In the current case, the price per unit of \$1.12 is generating the operating profit of \$580,000.
2. If the production unit offered for the Real Mint is very high, in other words, in order to produce the required quantity of Real Mint, the production of Lemon Crme should be cut off to its actual position. In that case, the offer should be rejected, as the current price offered per unit is relatively very low than the price of the Lemon Crme and acceptance of the order, will result in <https://assignbuster.com/contribution-margin-and-breakeven-analysis/>

the overall lose of operating profit.

Part B.

If the breakeven volume of Lemon Crme cookies in this new plant is 650, 000 packs then she should not accept to buy the new unit. There are several reasons for that. Firstly, it would not be profitable for the company to purchase the new unit because the expected sales increase for the next month is 600, 000 units. If the company purchases this new unit and the expected sales target is achieved i. e. 600, 000, even then the net result would be the " Operating Lose". Hence, this would be an irrational decision to buy the new unit because it won't simply generate income for the company. Secondly, if the company purchases this new unit and continuing to make peanut butter cookies, it would be not profitable as well.

As the company has only two possibilities which can influence the decision making whether to purchase the new unit or not and the net result of both the options are unfavorable for the company and will cause operating lose for the particular period, Maria should not Buy this unit.