Free case study on ajax cost accounting

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Statement of the Problem

Ajax Manufacturing Company (Ajax) is a manufacturing company that wishes to an average gross margin of 35% across its products. It sets its prices using a traditional cost accounting method and then adding a 35% mark up. Management has found this approach to be puzzling, with the actual results differing from the projected results. Case in point is the significant decrease in volume sold of Product B despite the reduction in selling price and the absence of competition in Product C market despite a computed higher-thanexpected margin.

The company modified its cost accounting approach by doing the following: allocating labor hours for units produced, materials charging based on cost rather than labor costs, and machine hours used in lieu of labor hours to allocate volume driven costs.

If a transactions-based approach is used in the case of Ajax manufacturing, how will this company compare in terms of financial performance with the two previous methods of cost accounting? What management directives should Ajax take in light of these findings?

Executive Summary

Ajax Manufacturing Company (Ajax) is an entity that is competing in a market that requires products A, B and C. The company has state of the art equipment relies on a simple formula to come up with a selling price and a desired gross margin of 35%. However, as in all cases the actual financial results are different from the projections. Ajax maintains a 35% gross margin from Product A, but Product B has experienced significant reduction in volume despite a decrease in price with Product C has an unbelievably high gross margin but is not attacked by competition. Clearly, there needs to be an examination of how Ajax

determines the cost of the goods sold.

A modification was conducted to reflect some of the changes that management deemed important, such as the use of machine hours in place of labor hours and the main determinant of allocating costs.

The use of transactions-based costing shows the real financial performance of Ajax. Transactions-based cost determination shows how much a product is manufactured by considering the number of processes needed to produce it, rather than allocating costs based on labor or machine usage.

The calculated manufacturing costs and gross margins as well as the Net Income calculated as a result of using these manufacturing costs are summarized below.

Projected Selling Price

at 35% gross margin

The calculations show that the company will optimize its revenues by manufacturing Product A and selling at current price (162. 61), manufacturing Product B and lowering its prices to 119. 76 per unit to gain back market share, and discontinue the production of C if it does not sell at 261. 29. All these directives will enable to company to realize at least 35% gross margin from each product. The optimum profit will be reached if Products A and B are sold by Ajax. Product A is produced and sold at 95. 42 to make net income of 1, 005, 900 and product B at 119. 76 to make a net income of 721, 750. 00. This will yield a total net income of 1, 727, 650. 00.

Analysis

The table below shows the net income calculation of using the traditional cost and selling profit approach. The total company income, selling at the given units and prices is 1. 42 million.

Table 1 Net Income Calculation and Percent Contribution to Total Income

Net Income

% Contribution to total income

The second approach undertaken yielded the following cost calculations. This approach does not stray far from the original, but shifts the allocation of costs from labor based to machine based.

Projected Selling Price

at 35% gross margin

 Transactions-based gross margins show the real manufacturing costs of Ajax. Product A provides a 62% return but its contribution is negated by Product C.

2. Removing Product C from the mix increases net realizable income by 300 thousand (net income of 1. 7 M). If the product is retained and sold at current price, net income is reduced by 9, 000.

3. If Ajax wishes to continue producing all three products at 35% gross

margin, it should sell A at 95. 42, B at 119. 76 and C at 261. 29.

4. To optimize its revenues, Ajax could produce more of Product B and sell it at reduced prices up to 119. 76 per unit. For Product C, it should sell at 261. 29 or discontinued if the market can bear a price below 169. 84/unit. Product A should be kept at its current selling price level. If Product C is discontinued, Ajax will benefit most from using the feed up resources to produce more of Product A.

5. The maximum gross revenue that Ajax will achieve is if it produces and sells 30, 000 units of one product (30, 000 is the sum of the number of units produced by Ajax). The table below shows that the largest net income possible is if the market can bear the cost of Product C. The net income of selling only A or only B is less than the combination of selling A (10, 000 units) and B (15, 000 units) and discontinuing C, as shown above.