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## **Budgeting**

### Budgeting

It is very important for the management of the production or manufacturing business to identify the nature of the costs and expenses to maximize the profits of the business. In a manufacturing business, the management must utilize their labor and machines to minimize the idle time. Moreover, the main expenses of the business such as, rent of the factory and utility bills are those fixed expenses that must be recovered from the proper activity level of the production. Therefore, in these circumstances, the costs which are already incurred are called the sunk costs of the business and the future expenses of the business are known as the relevant costs of the business. In the decision making of a production of non-budgeted products, the relevant cost of the production plays an important role. (Caplan)

In the current scenario, the relevant cost for the production of product C is the direct material cost of the product. Moreover, the opportunity cost will be generated if the production of product B is replaced by the production of product C. Therefore, losing the revenue on the sales of product B is another relevant cost. As the cost structure of the product C is similar to product B, however, the reduction in the direct material cost by \$12 per unit will increase the profitability. The overall gross profit will be \$150, 000 after the sale of one thousand units and the reduced manufacturing cost will increase the contribution per unit. Therefore, if the management of the business decides to produce the product C, then the production and sale of the product C will increase the contribution per unit by \$12. The management of the business must produce the product C to maximize the profit and to

minimize the fixed cost per unit or ' sunk cost' per unit for the accounting period. (Hermanson, Edwards & Invacevich, 2011)

The offers from the new customers or the revised production level require the proper planning of relevant costs of the business. In the manufacturing business, there are many expenses which cannot be reduced according to the activity level of the business such as the rental expenses and the wages of the labor. Therefore, in these circumstances, if the management of the business is asked by the new customers to sell the products at much lesser prices or a lower contribution per unit, then the management of the business must accept these offers. In the current scenario, if the selling price per unit is reduced by \$10 then it will reduce the contribution per unit of product C by \$10. Therefore, the product C will generate the profit of \$2 per unit as compared to the product B. The management of the business must analyze and plan the production accordingly. In the current scenario, it is indicated that the company will suffer the cost of material of product C and the labor is available for the production without any further expenses. Therefore, whenever, there is a spare labor and machines available for the production, then the management of the business must accept the new orders. In the current case, the business will generate the profit of \$2 on the sale of each product. According to the theories and practical business tactics, it is favorable for the business to generate the \$2 profit on each product, instead of wasting the labor and machinery of the business. Accepting the order of 1, 000 products will generate the net profit of \$2, 000 for the business. Therefore, by considering the relevant costs of the production, the management will generate the net profit of \$2, 000 for the accounting year.

(Walther, 2010)

This new order for the production of product C must be accepted according to the financial and non financial basis. In the current scenario, there is a clear signal that the labor and machinery is available for the production of product C. Therefore, to utilize the ' sunk cost' or the fixed cost of the business, it is in the favor of the business to accept the new order to generate the profit. Moreover, if the management of the business declines the new offer, then there will be no reduction in the wages if labor and other fixed expenses. Therefore, on the financial basis, the management must consider the relevant cost of the production of product C and the selling cost. The main non-financial benefit for the business is that it is very difficult to find new customers for the manufacturing businesses and in the current scenario; the new customer is a positive signal to the business. Therefore, the management must accept the order and develop strong business relations with the new client. Another non-financial benefit from accepting the current order is that it will keep the labor of the business at the working stage. By eliminating the element of idle labor, the skills of the labor will improve and help in reducing the material losses. Moreover, the labor will consume less time in producing the units for the clients in the future.

(Chapter 5 - Information for decision making)

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