Essay on aja manufacturing transaction-based cost accounting

Business, Company

Statement of the Problem

A hypothetical company called Ajax Manufacturing Company (Ajax) is using a cost accounting method that is considered traditional. Ajax is a manufacturing company produces 3 products (A, B and C) and accounts for costs by computing a standard cost based mostly on labor hours used and accounts for margins by slapping a 35% add on to that standard costs.

The results of this approach has puzzled management. Product B has sold less even at reduced prices and Product C sells well even at selling prices. The company's controller did some pencil pushing, substituting machine hours as a determinant rather than labor costs.

Executive Summary

Ajax Manufacturing Company (Ajax) is a corporation that manufactures and sells products A, B and C in the industrial market. The company has invested in proper equipment and claims to be able to compete with anyone. The dilemma of the company is that the projections on profit do not match their actual results.

This is despite a simple formula that Ajax follows to predict gross margins. It slaps a 35% margin on the calculated manufacturing costs. The manufacturing cost is determined based on standard costs determined using labor hours used.

This approach is not without problems. Generally, the labor-hour allocation approach to cost calculations has not given Ajax a better understanding of the market and the efficiency of its pricing strategy. The company controlled

presented a modified approach by using machine hours in lieu of labor hours to allocate costs. But the fundamental error of these approaches that of using a small portion of the total cost as determinant of allocating costs is challenged by the use of an updated approach that is the use of transactions as a more appropriate way of determining costs compared to labor or machine hours. This cost determination technique is a long-run, capital-cost recovery approach.

The use of transactions-based costing shows that Ajax will realize the highest possible revenues by manufacturing Product A to be sold at 162. 61 per unit, Product B to be sold at the very least at 119. 76 per unit with the purpose of gaining market share. Product C should be discontinued if it does not sell at 261. 29. All these price positions will enable the company to retain a 35% gross margin across all product lines.

Analysis

The traditional approach yields a net income of 1. 415 M for Ajax, with products A and B contributing about 40% of total net income each. Product C is a low-volume product contributing 19% of calculated net income, despite having a computed gross margin of 50%.

Table 1 Traditional Cost Calculation showing Net Income and % Contribution

Net Income

% Contribution to total income

The approach taken by the company’s controller is shown below. This calculation substitutes machine hours for labor costs for some of the over

head labor. By adopting this strategy, we can see that the contribution of Product A is higher than 40%, while B and C drop to disappointing levels.

Table 2 Modern Cost Accounting Calculation showing Net Income and % Contribution

Net Income

We compute transactions-based cost accounting by using the number of processes or transactions to determine costs. The use of transactions as a determinant focuses on the recovery of long-term investments rather than just variable costs. The summary calculations are shown below.

Conclusions and Recommendations

Based on the following calculations, Ajax management should:

1. Transactions-based calculations show that the real gross margins position of Ajax. Product A provides a very high return of 62% margin, higher than what Ajax management originally computes as 35%. Product C however, is not providing a 50% gross margin and negates the effect of Product A. This is the reason why despite what seemed to be a profitable segment, no competitor has ventured into the Product C market.

2. Management should remove Product C from their line to increase its net income to 1. 7 million. This shows how big a discount Ajax is giving the market by selling their products at a loss.

3. A 35% gross margin would mean that Ajax will price its line as follows:

a. A at 95. 42

b. B at 119. 76

c. C at 261. 29.

4. The best way to increase revenues is to increase the market share of Product B by selling it at reduced prices up to 119. 76 per unit. If Ajax wants to continue producing C, it should only do so if it can sell the product at 261. 29 to retain a 355 gross margin. If it cannot do that, the absolute floor price Ajax must be willing to take should nto fall below 169. 84/unit. No change should be done on the price of Product A unless management wants to increase its market share by lowering Product A’s price.