

Prestige data service



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Appraise the results of operations of Prestige Data Service. Is the subsidiary really a problem to Prestige Telephone Company? Consider carefully the differences between reported costs and cost relevant for decisions that Daniel Rowe is considering. 1. The prestige Data Services grew from the needs of the Prestige Telephone Company to meet their needs of data handling at the time but the problem now is that the company is still operating at a loss. But is that a problem for the parent company?

We do not think so, if the Prestige Data Services does not exist anymore, the Prestige Telephone still have to pay for the cost such as: lease, maintenance, computer services... , but they get no contribution. In order to check if the data provided are relevant to make the decision at hand, the data has to satisfy the following criteria for it to be a relevant data. •It has to be an accepted future revenue or cost, •It must have an element of difference among the alternatives

The future alternative may be to short down the site but some costs need to be considered- the cost of getting these services from another company, the loss of the corporate service revenue. Also there are benefits to be considered if this subsidiary is not existing, the vacated space could be used for another profitable purpose, since the parent company provide some services to the Data services, these services can be canceled, the employees can also be reduced thereby saving on labour costs.

If all these costs are compared this will give a clear indication of the more profitable option and this will give good guidance in decision making

II) Assuming the company demand for service will average 205 hours per

month, what level of commercial sales of computer use would be necessary to break even each month? Firstly, let's have a look at the reports which Rowe received from the Prestige Data Services to do the Cost -Volume - Profit analysis. The cost or expenses listed in the Exhibit 2 consists of both fixed and variable cost. Some cost includes a fixed cost and a variable cost which needs to be broken down.

As stated in the information of the company, operating salaries include a fixed amount to pay the six people as well as hourly amounts paid for those who support computer's operation. The former will be the fixed cost and the last will be variable cost since it varies according to the output which is the operation hour. To calculate these amounts, let's have a look at Exhibit 1 and 2. In January, total operating wages is \$ 29, 496, which consists of a fixed amount and the hourly paid portion based on 329 revenue hours when the computer was in operation.

In February, the fixed amount is unchanged, but the revenue hours varies to 316, leading to the operating salaries to be \$ 29, 184. The difference in operating salaries is caused by the difference in operating hour. So we can get the amount paid per hour for operating: Comparing between February and March, doing the same calculation as above we also get the same variable cost of operating salaries, that is \$24/hour. Calculate the fixed amount of operating wages which will be the fixed cost: $\$29496 - \$24 * 329$ hours = \$21600

Let's use the information and reports in March 2003 as the latest for the analysis We will assume that sale promotion and materials are fixed costs,

because with the same number of equipment so it can be considered unchanged. So in this case, only power and hourly paid operating wages are variable costs, all others are fixed costs. We also can assume that the power is mostly spent in revenue hour for operating computer. So we can calculate the power cost per hour: and we consider it \$5 per hour for power cost. The total relevant monthly fixed costs of the company is: $240 + 95000 + 5400 + 25500 + 680 + 21600 + 12000 + 9000 + 11200 + 10317 + 8083 + 15236 = 223,256$ We can easily get the variable costs per hour: $\$24 + \$5 = \$29$ Finally, we have the equation as follows to calculate the break even volume each month, with the assumption of 205 hours service demand per month of the Prestige Telephone Company: $205 * \$400 + \text{break-even hours} * \$800 + \text{other revenue} = (205 + \text{break-even hours}) * \$29 + \$223,256$ Break-even hours = In this equation, the contribution margin per hour is $(\$800 - \$29)$ So with the reports of March 2003, Prestige Data Services need to sell out 174.6 commercial hours of computer use to break even. III) Estimate the effect on income each of the options Rowe has suggested if Bradley estimates as follows : Let's analyze different options for the Prestige Data Services, which Mr Rowe provided and asked Bradley to estimate the effects on profits. We will still use the information in March, 2003 as the input. a. Increasing the price to commercial customers to \$1,000 per hour would reduce demand by %30. So in this case, the total revenue hours will be: $138 * (1 - 0.3) = 96.6$ hours, and could be roundup to 97 commercial hours of selling computer use. Because the fixed costs would not change, the change in commercial hours and the price would affect the contribution number. So we get the total contribution: $\text{Contribution} = 97 \text{ hours} * (\$1000 - \$29) = \94187 Let's calculate the contribution in March 2003 (at present) and have a

comparison: Contribution at present = $138 \text{ hours} * (\$800 - \$29) = 106398$

.....(1) So we can see, the contribution in case of increasing price to commercial hours, leading to reducing the demand by 30% is \$12211 lower than the current contribution.

Hence, income would go down if we do like this way. The Prestige Data Services should maintain the current price other than increasing it. b.

Reducing the price to commercial customers to \$600 per hour would increase demand by 30%. The demand in this case is: $138 * (1 + 0.3) = 179.4$, so we will take the number of 179 hours. Then, the contribution with 179 hours and \$600 price per hour will be: $179 * (\$600 - \$29) = \$102209$

Comparing to the contribution at present (1), we find out that contribution per month would be slightly reduced (\$4189) with this second option.

Therefore, income would also decrease a little. c. Increased promotion would increase sales by up to 30%. Bradley is unsure how much promotion this would take. (How much could be spent and still leave Prestige Data Services with no reported loss each month if commercial hours were increased 30%)?

The commercial hours when sales go up by 30% is: $138 * (1 + 0.3) = 179.4$, can be round down to 179 hours. Contribution with 179 revenue hours is: $179 * (\$800 - \$29) = \$138009$

So the contribution would increase by an amount of: $\$138009 - 106398 = 31611$, which is not a small number. Because the contribution would be higher, the income would increase, and the company would have \$31611 to spend on sale promotion activities and still get no loss. d. Reducing operations to 16 hours on weekdays and eight hours on Saturdays would

result in a loss of 20% of commercial revenue hours. Firstly, let's analyze what they could save by reducing to 16 hours operating on weekdays, which equals two-third of revenue hours at present.

Because the operating people who received fixed salaries would work less than normal (two-third a day), so of course they would be paid less, and also the material cost might be saved also because of less working hours.

Assuming that these two fixed costs can be reduced proportionally to the operation hours, so the company can save: $(\$21600 + \$10317)/3 = \$10639$

But what would they lose? They lost 20% of commercial revenue hours. So total demand would be only: $138 * (1 - 0.2) = 110.4$, can be round down to 110 hours. Then the contribution in this case would be: $110 * (\$800 - \$29) = \$84810$

Compared to the value in (1), we can find out that the contribution would reduce by amount of $(\$106398 - \$84810) = \$21588$, while the company only can save \$10639. So following this option, the income would still be reduced, and this is not a good solution. In conclusion, looking at the analyzed result in the options, we think the option (c), which is increasing sale promotion would be the most optimal solution. IV) Can you suggest changes in accounting and reporting system now used for operations of Prestige Data Services which would result in , or useful information for Rowe and Bradley?

The accounting system used to report the income statement is the traditional approach, also known as the absorption approach, which simply provides a financial account of the condition of the organization at given points in time. It is used mainly to provide information required by external

interests say stockholders and government agencies. The Contribution-Margin approach is a better way of presenting this income statement. Contribution-Margin approach separates costs based on the primary distinction of cost behaviour pattern.

It deducts variable costs from sales to get the contribution margin and then deducts fixed costs to measure profit. This approach makes it easier to understand the impact of changes in sales demand on operating income, because before a company can make profit, their fixed costs must exceed the contribution margin. In other words the contribution approach stresses the role of fixed costs in operating income. This approach is recommended for project abandonment, continuation and pricing and it fits perfectly to the decision to be made by the president.