

This report assesses the opportunity

Business



This report assesses the opportunity offered to Carol's Cookies by the order for 20,000 boxes of Crunchies by a supermarket chain. The report compares both the short term and long term by using two costing methods – relevant costing and full costing. Using relevant costing it has been shown that purely on a financial basis accepting the order in the short term will increase relevant cash flow by £105,000, even with the loss of revenue and production of 6,000 boxes of Boosters.

This is due to having 60 tonnes of Material B in stock and the under utilisation of Labour Grade 1. However, the weight of the short term financial gain must outweigh any risks associated with the reduced production of Boosters. In the long term the full costing approach shows Crunchies being sold at a loss. A repeat order would improve both the OAR and the utilisation of the Labour Grade 1. However, we would recommend that prior to accepting a contract for repeat orders the board should assess both the qualitative and quantitative factors as described in this report.

INTRODUCTION Carol's Cookies has been given the opportunity to supply a supermarket chain with 20,000 boxes of Crunchies, which could lead to future repeat business. Carol Snape, the Managing Director, who is keen to accept his order, has been advised by the Financial Account, Kevin Clark, that this would result in a net loss of revenue. The company is resource limited, therefore accepting the Crunchies order would reduce the available production capacity for their Boosters product. Kevin has calculated the loss to be £9,600 in respect of the reduced production of, and revenue from 6,000 boxes of Boosters. In the absence of the internal Management Account and before making a final decision, Carol has invited Group 9 Consulting to <https://assignbuster.com/this-report-assesses-the-opportunity/>

investigate and report in detail on the options. SHORT TERM RELEVANT COSTINGS KEVIN'S CALCULATIONS Kevin Clark, the financial accountant, is reluctant to accept the Crunchies order based on his calculations of the lost contribution of Boosters as detailed in Figure 1 below.

Figure 1 We have assumed Kevin applied the same methodology to the Crunchies order to calculate the potential profit. This results in the calculations shown in Figure 2 below. Figure 2 This would therefore result in Kevin calculating a total loss of £9,600 (lost profit due to lost production) + £13,000 (net loss of production) = £22,600 if the order is accepted. As we will demonstrate in the following sections this is not the best basis for making a short-term decision. RELEVANT COSTING METHOD For short term decision making purposes financial profit alone is inappropriate and insufficient.

In assessing the cash flows resulting from two alternatives, only future costs that will be relevant to the decision should be included. Assumptions for Relevant Costings Approach Based on further research it has been ascertained that the limiting factor in production capacity is machine based rather than labour based. In Figure 1, Kevin has taken into account the cost of 'Grade 1 Labour'. As it is Carol's policy to retain these workers on full pay irrespective of their current workload, the cost of 'Grade 1 Labour' is not relevant for the calculations. Furthermore, since 'Material A' is widely used within the firm, Kevin should have assumed the relevant cost to be the replacement cost of £0.

40/kg, instead of using the book value of £0.35/kg for all calculations. Additionally, the 'Fixed Overhead' is not relevant since it would remain unchanged irrespective of the decision taken and should therefore not be included in the calculations. Finally, the existing stock of 'Material B' can be only used for Crunchies, therefore if the order for Crunchies is not accepted this stock could be sold at its net realisable value. If the Crunchies order is accepted the stock of 60 tonnes is considered a sunk cost and therefore free-issued, however 20 tonnes of further material will need to be purchased at the replacement cost rate.

RELEVANT COSTING CALCULATIONSBased on above assumptions, Figures 3

and 4 below show the relevant costings for producing Boosters and

Crunchies respectively. Figure 3Figure 4SUMMARYFigure 5 below

summarises the result of accepting the Crunchies order using the relevant

costing approach. Figure 5On the basis of the above information and

calculations, as a one-off short term decision, Group 9 Consulting would

recommend accepting the order for Crunchies. **LONG TERM COSTINGSRE-**

CALCULATION OF FIXED OVERHEAD ABSORPTION RATEThe current Fixed

Overhead Absorption Rate (OAR) is based upon the total fixed costs of

£300,000 divided by the number of productive labour hours; currently 50,

000 hours per period. It has been assumed that both Labour 1 and Labour 2

contribute to the total productive labour hours and does not take into

account idle time.

It is necessary to re-calculate the Fixed OAR to reflect the change in total

productive labour hours that would result from accepting the Crunchies

order. The change in productive hours is illustrated in Figure 6 below. Figure

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Figure 7 below shows the impact on the Fixed OAR from accepting, or otherwise, the Crunchies contract. Figure 7 PROFITABILITY ANALYSIS If the contract for the production of Crunchies is accepted and the company's routine job costing system is used, Figure 8 below illustrates the resultant contribution of each product. For this calculation the re-calculated OAR from the previous figure is used for both products.

Figure 8 SUMMARY As can be seen Crunchies would be produced at a loss of £2.10 per box, but would reduce the fixed OAR and therefore increase the margin on all the other products produced by Carol's Cookies. CONCLUSIONS AND RECOMMENDATIONS Taking account factors such as Grade 1 Labour and Fixed Overheads along with current stock-holding, the profits derived from the initial sale of 20,000 boxes of Crunchies are greater than the profits obtained from selling 6,000 boxes of Boosters and Material B stock instead. Therefore Carol's Cookies should accept the initial order for Crunchies in this period, as this would produce a relative net inflow of funds of £105,000. When looking at the longer term, Crunchies appear to show a loss of £2.10 per box (as shown in Figure 8).

In order to gain a full understanding of the relative merits of producing Crunchies, or any other product, other factors should be taken in account before making a final decision. Therefore before making a recommendation we would need to factor in the long term strategies for capacity, plant, employment, growth, product mix, and marketing etc. which can not be easily altered in the short term. The two main considerations in the long term are the current under utilisation of Labour Grade 1 and the method of overhead absorption. It is implied that Labour Grade 1 utilisation is seasonal <https://assignbuster.com/this-report-assesses-the-opportunity/>

therefore it may be possible to manage demand in such a way as to level out the production.

Alternatively it may be necessary to examine the staffing level and skills.

The method for calculating Fixed OAR is based on the productive labour hours, therefore the non-productive hours are being absorbed in the product costs. In effect the cost of the inefficient use of Labour Grade 1 is being reflected in higher product costs. In addition, the following factors would need to be carefully considered prior to making a final decision: * To what extent will the reduction in volume of Boosters affect the existing customers?

* Staff are currently demoralised -o If labour is reorganised morale may suffer still furthero If staff are required to perform alternative or additional duties, morale may equally suffer (for example asking Grade 1 staff to perform Grade 2 activities)* The potential to expand the product range sold by the supermarket may increase and could lead to additional products being developed.* Supplying supermarkets raises some potential longer term risks, such as: o Price may fall further in response to additional pressure from the supermarketo If these sales become a larger proportion of the company's business, overall profitability will suffero There may be hidden infrastructure costs to support the supermarket's operations (Just In Time delivery, ordering systems etc.

)* Material B (nut-based) may contaminate other products that do not contain nuts (it is assumed that since Material B is not used by other products, no products other than Crunchies use nut based ingredients). It may be necessary to label all of the company's products as not being suitable for allergic customers and this could lead to lower sales of those

products.* Material B is already relatively expensive to purchase and, being nut based, the purchase price may fluctuate with season or supply/demand problems.* Once established it may be possible to add additional distribution channels for Crunchies and sell at higher prices (e. g.

corner shops/newsagents, vending machines etc).* Brand awareness may increase.* Crunchies may cannibalise the company's existing markets and products thus leading to lower sales of other products* With such low margins (or selling at a loss), competitors may retaliate with lower prices to regain market share affecting some or all of the company's products.* If Crunchies become a regularly produced product, it is possible that storage and transportation issues could arise. In conclusion as a one-off decision, Carol's Cookies should accept the Crunchies order.

A contract for repeat orders should not be accepted without taking into account the above factors, in particular the issue that Crunchies would be sold at a loss (based upon current costing procedures) and that Labour Grade 1 is under utilised. On a wider basis the under utilisation should be addressed irrespective of any decision regarding Crunchies. However, should this not be addressed then repeat order for 20, 000 boxes of Crunchies should be accepted to at least increase the Labour Grade 1 utilisation.