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Chapter 2 – Developing a Business Plan: Cost–Volume–Profit Analysis

COMPLETION

1.	Instead of rushing into a business right away, it is wise to develop a					
	ANS: busines	ss plan				
	PTS: 1	DIF: Easy	TOP: Planning in a new business			
2.	A	describes a	business' goals and its plans for achieving those goals.			
	ANS: busines	ss plan				
	PTS: 1	DIF: Easy	TOP: Planning in a new business			
3.		refers to the u	incertainty about the future operations of a business.			
	ANS: Risk					
	PTS: 1	DIF: Easy	TOP: Planning in a new business			
4.	The credit decisior	is money ns.	that investors will receive back from their investment and			
	ANS: return					
	PTS: 1	DIF: Easy	TOP: Planning in a new business			
5.	The and respond to	shows ho o market conditions.	ow the business will make sales and how it will influence			
	ANS: market	ing plan				
	PTS: 1	DIF: Easy	TOP: Marketing plan			
6.	The the product.	de	scribes how the business will promote, price and distribute			
	ANS: market	ing strategy				
	PTS: 1	DIF: Easy	TOP: Marketing plan			
7.	The business' proc	describes lucts by period.	s the predicted growth, market share and sales of the			
	ANS: sales for	precast				
	PTS: 1	DIF: Easy	TOP: Marketing plan			

8.	The section of a business plan includes a description of the relationships between the business, its suppliers, its customers, as well as a description of how the business will develop, service, protect and support its products or services.						
	ANS:						
	PTS:	1	DIF: Easy	TOP: Operating plan			
9.	The require perfor	ements and sou mance.	section of a b rces of capital, as well	usiness plan identifies the business' capital as describing the business' projected financial			
	ANS:	financial plan					
	PTS:	1	DIF: Moderate	TOP: Financial plan			
10.	The impac	t of the organis	section of a b ation.	usiness plan describes the social and environmental			
	ANS:	environmental	l management plan				
	PTS:	1	DIF: Moderate	TOP: Environmental management plan			
11.			is the business' fu	inding.			
	ANS:	Capital					
	PTS:	1	DIF: Moderate	TOP: Sources of capital			
12.			is the business' fu	unding that will be repaid within a year or less.			
	ANS:	Short-term cap	pital				
	PTS:	1	DIF: Moderate	TOP: Sources of capital			
13.	Credit	from suppliers	is a source of	for the business.			
	ANS:	Short-term cap	pital				
	PTS:	1	DIF: Moderate	TOP: Sources of capital			
14.			is the business' fu	inding that will be repaid after more than a year.			
	ANS:	Long-term cap	pital				
	PTS:	1	DIF: Moderate	TOP: Sources of capital			
15.	The fi suppor	nancial perform	nance section of the fir and	nancial plan includes projected financial statements			
	ANS:	cost-volume-	profit <mark>analysis</mark> ; budget	TS			
	PTS:	1	DIF: Moderate	TOP: Projected financial performance			

16 shows how profit is affected by changes in sales vol selling price of products and the various costs of the business.				d by changes in sales volume,	
	ANS:	Cost-volume-	–profit analysis		
	PTS:	1	DIF: Difficult	TOP: Cost-volume-	profit analysis
17.	The total v	variable costs.		is the difference betwe	een the total sales revenue and
	ANS:	total contribu	tion margin		
	PTS:	1	DIF: Difficult	TOP: Contribution n	nargin
18.	The	riable costs per	unit.	is the difference betwe	een the sales revenue per unit and
	ANS:	contribution r	nargin per unit		
	PTS:	1	DIF: Moderate	TOP: Contribution n	nargin
19.	[Sellir	ng price per uni	it – variable cost per	unit] x volume =	
	ANS:	total contribu	tion margin		
	PTS:	1	DIF: Moderate	TOP: Contribution n	nargin
20.	A desi	ired level of ov	erall profit for a busi	ness is called	·
	ANS:	target profit			
	PTS:	1	DIF: Moderate	TOP: Target profit	
TRU	E/FALS	SE			
1.	The fi	rst step in start	ing a business is to d	evelop a business plan.	
	ANS: busine	T ess	PTS: 1	DIF: Easy	TOP: Planning in a new
2.	The fi	rst step in start	ing a business is to se	et up a corporation.	
	ANS: busine	F	PTS: 1	DIF: Easy	TOP: Planning in a new
3.	A bus	iness plan is a	static document. Onc	e created it should not r	need to be updated.
	ANS: busine	F	PTS: 1	DIF: Easy	TOP: Planning in a new

4. A business plan typically includes a description of the business, a marketing plan, an operating plan, an environmental management plan and a financial plan.

	ANS: T business	PTS:	1	DIF: Moderate	TOP: Planning in a new
5.	A business plan shou	ld be vi	ewed as an opp	portunity to identify mi	istakes before they could happen.
	ANS: T business	PTS:	1	DIF: Moderate	TOP: Planning in a new
6.	In cost behaviour, ac	<mark>tivity</mark> af	fects the way c	osts behave.	
	ANS: T	PTS:	1	DIF: Moderate	TOP: Cost behaviour
7.	In cost behaviour, pro	<mark>ofit</mark> affe	cts the way cos	sts behave.	
	ANS: F	PTS:	1	DIF: Moderate	TOP: Cost behaviour
8.	Fixed costs per unit v	will rem	ain constant as	activity changes.	
	ANS: F	PTS:	1	DIF: Moderate	TOP: Fixed costs
9.	A fixed cost does not	respon	d to changes in	an activity such as sal	les volume.
	ANS: T	PTS:	1	DIF: Moderate	TOP: Fixed costs
10.	A fixed cost responds	s directl	y to changes in	an activity such as sa	les volume.
	ANS: F	PTS:	1	DIF: Moderate	TOP: Fixed costs
11.	Fixed costs per unit v	will cha	nge as activity	changes.	
	ANS: T	PTS:	1	DIF: Moderate	TOP: Fixed costs
12.	Variable costs will re ANS: T	emain co PTS:	onstant per unit 1	as activity changes. DIF: Moderate	TOP: Variable costs
13.	Variable costs per un	it will c	hange as activi	ty changes.	
	ANS: F	PTS:	1	DIF: Moderate	TOP: Variable costs
14.	A variable cost respo	nds dire	ectly to changes	s in an activity such as	sales volume.
	ANS: T	PTS:	1	DIF: Moderate	TOP: Variable costs
15.	Total costs are the su	m of th	e fixed costs an	d variable costs.	
	ANS: T	PTS:	1	DIF: Moderate	TOP: Total costs
16.	Contribution margin contributes toward pr	is the an rofit.	mount left over	after a sale to cover th	he fixed costs, which then
	ANS: T	PTS:	1	DIF: Moderate	TOP: Contribution margin

17.	Sales less fixed costs equal contribution margin.					
	ANS: F	PTS:	1	DIF: Moderate	TOP: Contribution margin	
18.	Sales less variable co	osts equ	al contribution	margin.		
	ANS: T	PTS:	1	DIF: Moderate	TOP: Contribution margin	
19.	All contribution mar	gin crea	ited past the bro	eak-even point will con	ntribute towards profit.	
	ANS: T	PTS:	1	DIF: Moderate	TOP: Contribution margin	
20.	All contribution mar fixed costs.	gin crea	ted prior to the	break-even point will	contribute towards covering	
	ANS: T	PTS:	1	DIF: Moderate	TOP: Contribution margin	
21.	All contribution mar	gin crea	ted prior to the	break-even point will	contribute towards profit.	
	ANS: F	PTS:	1	DIF: Moderate	TOP: Contribution margin	
22.	Only fixed costs are volume in the profit	deducte equation	d from the sell n for determina	ing price per unit, with tion of profit.	n the result then taken times sales	
	ANS: F volume to achieve a	PTS: target p	1 rofit	DIF: Moderate	TOP: Finding the unit sales	
23.	The break-even poin	t is the	point that total	revenues equal total co	osts.	
	ANS: T point	PTS:	1	DIF: Moderate	TOP: Finding the break-even	
24.	The break-even poin	t is the	point that total	revenues exceed total	costs.	
	ANS: F point	PTS:	1	DIF: Moderate	TOP: Finding the break-even	
25.	The break-even poin	t is the	point that total	revenues are less than	total costs.	
	ANS: F point	PTS:	1	DIF: Moderate	TOP: Finding the break-even	
26.	The break-even poin	t is the	point that total	revenues equal target	profit.	
	ANS: F point	PTS:	1	DIF: Moderate	TOP: Finding the break-even	
27.	If a business were co determine the impac	oncerned t on pro	l about raising fits and the res	the price of their good ulting changes in costs	s, CVP analysis would help	
	ANS: T analysis	PTS:	1	DIF: Difficult	TOP: Cost-volume-profit	

28. CVP can be an absolute decision-making tool. Faced with a change in costs or prices, one need look only to the CVP results to make a complete decision.

ANS: F PTS: 1 DIF: Difficult TOP: Cost–volume–profit analysis

29. CVP is not an absolute decision-making tool. Faced with a change in costs or prices, one should also consider the impact on customers as well as the CVP results to make a complete decision.

ANS: T PTS: 1 DIF: Difficult TOP: Cost–volume–profit analysis

30. When analysing an alternative set of plans, CVP is but one tool. The impact on customers should also be considered.

ANS: T PTS: 1 DIF: Difficult TOP: Cost–volume–profit analysis

MULTIPLE CHOICE

- 1. I. The first step in starting a business is to develop a business plan.
 - II. The first step in starting a business is to set up a corporation.
 - III. A business plan is a static document that if done right will not need updating.
 - IV. A business plan should be viewed as an opportunity to identify mistakes before they occur.

Which of the above is correct?

- a. I. only.
- b. I. and II only.
- c. II and III only.
- $d. \quad I \ and \ IV \ only.$
- e. I, II, III and IV.

ANS: D	PTS: 1	DIF: Moderate	TOP: Planning in a new
business			

2. Which of the following would NOT be included in a typical business plan:

- a. The marketing plan.
- b. The financial plan.
- c. The weekly sales plan.
- d. The operating plan.

ANS: C	PTS: 1	DIF: Easy	TOP: Planning in a new
business			

3. The primary concern of creditors and investors is:

a. risk.b. return.c. both of the opt	ions given		
ANS: C business	PTS: 1	DIF: Easy	TOP: Planning in a new

4. Fixed costs:

a. In the short term do not respond to changes in volume.

	b. c. d.	b. respond in the opposite direction of changes in volume.c. change in proportion with changes in volume.d. will always be the same from one period to the next.					
	AN	S: A	PTS:	1	DIF: Moderate	TOP: Fixed costs	
5.	Barn min a. b. c. d.	ney's Brick C imise the imp To produce a To downsize. Sell the busin Lay off the sa	o. has high act of these nd sell as n less to som lary emplo	fixed costs e fixed cost nany units a eone else. oyees.	s such as building, mach s. A strategy for Barney as possible.	inery and salaries. Barney desires would be?	
	AN: busi	S: A iness	PTS:	1	DIF: Moderate	TOP: Planning in a new	
6.	Whi a. b. c. d.	ich of the foll Equipment. Cost of produ Salary plus co Telephone us	owing best acts sold to commission age.	represents customers. employees	an example of a fixed co	ost?	
	AN	S: A	PTS:	1	DIF: Difficult	TOP: Fixed costs	
7.	Tota a. b. c. d.	al variable cos do not respon respond in the change in pro will always b	sts: d to chang e opposite portion wi e the same	es in volum direction to th changes from one p	ne. o changes in volume. in volume. veriod to the next.		
	AN	S: C	PTS:	1	DIF: Moderate	TOP: Variable costs	
8.	Whi a. b. c. d.	ich of the foll Equipment. Cost of produ Salary plus of Telephone us	owing best acts sold to commission age.	represents customers. employees	an example of a variable	e cost?	
	AN	S: B	PTS:	1	DIF: Difficult	TOP: Variable costs	
9.	Wh a. b. c. d.	ich of the follo Fixed costs a Total variable None of the c Fixed costs.	owing cost nd variable costs. options give	s change is costs. en.	in direct proportion to t	he volume?	
	AN	S: B	PTS:	1	DIF: Moderate	TOP: Variable costs	
10.	The a. b. c. d.	definition of Selling price Selling price Selling price None of the a	contributic per unit – v per unit – f per unit – t bove.	on margin p variable cos ïxed costs. otal costs.	er unit is: st per unit.		
	AN	S: A	PTS:	1	DIF: Easy	TOP: Contribution margin	

to

11. The unit sales volume at which a business earns zero profit is called:

- a. Zero-profit point.
- b. Total costs.
- c. Contribution margin per unit.
- d. Break-even point.

ANS: D

DIF: Easy

TOP: Break-even point

12. The profit equation for a given sales volume is:

PTS: 1

- a. [Selling price per unit x volume] + [variable cost per unit x volume] total fixed costs.
- b. [Selling price per unit x volume] [break even point] total fixed costs.
- c. [Selling price per unit x volume] + [break even point] + total fixed costs.
- d. [Selling price per unit x volume] [variable cost per unit x volume] total fixed costs.

ANS: D PTS: 1 DIF: Moderate TOP: Profit equation

- 13. Barb's Best Pies sells a meat pie for \$5.00. Variable costs are \$3.00 per unit and fixed costs for the period are \$4000. The profit on the 2001st pie sold is:
 - a. \$2.00.
 - b. \$5.00.
 - c. \$3.00.
 - d. \$ 0 -.

ANS: A PTS: 1 DIF: Difficult TOP: Profit calculation

- 14. Widget World makes a widget that is sells for \$10 per unit. The variable costs are \$7 per unit. Assuming the business has normal fixed costs, and the break-even point is 350 units, what are the total costs at break even?
 - a. \$4500.
 - b. \$3500.
 - c. \$12 000.
 - d. \$7500.

ANS: B	PTS: 1	DIF: Difficult	TOP: Finding the break-even
point			

Example 2.1

The information below is used for the following problems.

Leslie's Soccer Balls sells soccer balls for \$20 each and incurs variable costs of \$15 per ball. Leslie's break-even point is 40 000 units.

- 15. Refer to Example 2.1. What is the total of Leslie's fixed costs?
 - a. \$2000.
 - b. \$8000.
 - c. \$200 000.
 - d. None of the options given.

ANS: C PTS: 1 DIF: Difficult TOP: Fixed costs

- 16. Refer to Example 2.1. What is Leslie's profit when 50 000 units are sold?
 - a. \$50 000.
 - b. \$250 000.
 - c. \$1 000 000.

	d. None of the option	ons given.		
	ANS: A volume to achieve a	PTS: 1 target profit	DIF: Moderate	TOP: Finding the unit sales
17.	 Refer to Example 2.1 a. \$500 000. b. \$125 000. c. \$75 000 loss. d. None of the option 	I. What is Leslie's protons given.	fit when 25 000 units a	are sold?
	ANS: C volume to achieve a	PTS: 1 target profit	DIF: Easy	TOP: Finding the unit sales
	Example 2.2			
	The information belo	ow is used for the follo	wing problems.	
	Garrison's Gaskets h price is \$5 per unit.	as variable costs of \$2	per unit and fixed cos	ts of \$40 000. Garrison's selling
18.	 Refer to Example 2.2 a. 8000 units. b. 20 000 units. c. 13 333 units. d. None of the option 	2. What is Garrison's b ons given.	preak-even point?	
	ANS: C point	PTS: 1	DIF: Moderate	TOP: Finding the break-even
19.	Refer to Example 2.2 \$100 000? a. 33 333 units. b. 46 667 units. c. 20 000 units. d. 28 000 units.	2. How many units wil	l Garrison's have to se	ll in order to earn a profit of
	ANS: B volume to achieve a	PTS: 1 target profit	DIF: Moderate	TOP: Finding the unit sales
20.	Refer to Example 2.2 unit, and sells 100 00 a. \$300 000. b. \$100 000. c. \$60 000. d. None of the optio	2. How much profit wi 00 units? ons given.	ll Garrison's earn if it	cuts its selling price to \$3 per
	ANS: C volume to achieve a	PTS: 1 target profit	DIF: Moderate	TOP: Finding the unit sales

SHORT ANSWER

1. What are the three main purposes of a business plan? Discuss each of the three purposes.

ANS:

First, the business plan helps the entrepreneur visualise and organise the business and its operations. It helps to evaluate the plan, develop new ideas, and refine the plan. Mistakes may be identified and corrected prior to implementing the plan.

Second, the business plan serves as a 'benchmark' for measuring the actual performance of the business. Plans for future activities can then be modified.

Third, the business plan helps the business obtain financing. The business plan helps creditors and investors assess the expected risk and return associated with the business.

PTS: 1 DIF: Moderate TOP: Planning in a new business

2. What are the two primary concerns of investors? Discuss each.

ANS:

One concern is the level of risk associated with the investment. Risk refers to the uncertainty existing about the future operations of the business. The other concern is return. Return refers to the money that the investor will receive back from their investment and credit decisions.

PTS: 1 DIF: Moderate TOP: Planning in a new business

3. What are the five parts of the business plan? Discuss each.

ANS:

The five parts of the business plan are a description of the business, a marketing plan, an operating plan, an environmental management plan and a financial plan.

The description of the business discloses the type of business and product. It describes how the business is organised. It discloses where the business is located. The objectives of the business are listed, along with potential customers.

The marketing plan shows how the business will influence and respond to market conditions. It provides evidence of the demand for the business' product or services. It describes the current and expected competition in the market and relevant government regulations.

The operating plan includes a description of the relationships between the business, its suppliers, and its customers, along with a description of how the business will develop, service, protect and support its products or services. It also includes any other influences on the operations of the business.

The environmental management plan looks at the financial and environmental performance of business through the development and implementation of accounting systems and practices that reduce the environmental impacts of business activities.

The financial plan discloses the capital requirements and sources of capital, and describes the business' projected financial performance.

PTS: 1 DIF: Difficult TOP: Planning in a new business

4. What is the purpose of the description of the business section of the business plan?

ANS:

The description of business section of the business plan discloses the type of business and product. It describes how the business is organised. It discloses where the business is located. The objectives of the business are listed, along with potential customers. The organisation of a business and its personnel can have a major impact on the success of the business. The investors need to be able to evaluate the items contained in this part of the business plan in order to assess the long-term potential of the business.

- PTS: 1 DIF: Moderate TOP: Planning in a new business
- 5. What is the purpose of the marketing plan section of the business plan?

ANS:

The marketing section of the business plan shows how the business will influence and respond to market conditions. It provides evidence of the demand for the business' product or services. It describes the current and expected competition in the market and relevant government regulations. This section receives considerable attention from creditors and investors, as the marketing of a product is critical to the long-term success of a business. This information helps the manager think about the business' activities related to sales. It shows investors and creditors how well the manager has thought about the business' sales potential and how the business will attract and sell to customers.

PTS: 1 DIF: Moderate TOP: Marketing plan

- 6. Doggie Donuts sells treats for pets for \$5 per box. The variable costs per box are \$3. Doggie Donuts' fixed costs total \$20 000.
 - a. Calculate the contribution margin per box.
 - b. Calculate the break-even point in boxes.
 - c. Calculate the profit that Doggie would earn if sales total 30,000 units.

ANS:

- a. \$2 = \$5 \$3
- b. $10\ 000\ units = \$20\ 000/\$2\ per\ unit$
- c. $$40\ 000 = $2\ \text{per unit} \times 30\ 000\ \text{units} $20\ 000$

PTS: 1 DIF: Difficult TOP: Finding the break-even point

- 7. Bill produces a miracle tool. His variable costs are \$20 per unit and his fixed costs are \$25 000. His break-even point is 30 000 units.
 - a. What is Bill's selling price per unit?
 - b. What is Bill's profit at 50 000 units of sales?
 - c. What would Bill's profits at 50 000 units of sales be if Bill were able to reduce his variable costs by \$5 per unit?

ANS:

- a. 30 000 units = \$25 000/contribution margin per unit Contribution margin per unit = \$0.83 Selling price per unit - \$20 = \$0.83 Selling price per unit = \$20.83
- b. $(\$0.83 \times 50\ 000) \$25\ 000 = \$16\ 500$
- c. $[(\$20.83 \$15.00) \times 50\ 000] \$25\ 000 = \$266\ 500$

8. If variable costs increase, and fixed costs and the selling price remain constant, what will happen to the break-even point? What will happen to profits?

ANS:

If variable costs rise, the contribution margin will fall. This will cause the break-even point to rise. The same level of profit will be attained with higher unit sales.

PTS: 1 DIF: Difficult TOP: Cost-volume-profit analysis

9. If fixed costs increase, variable costs and the selling price remain constant, what will happen to the break-even point? What will happen to profits?

ANS:

If fixed costs increase, it will take more unit sales to break even. More units will have to be sold to attain a profit.

PTS: 1 DIF: Moderate TOP: Cost–volume–profit analysis

10. Suppose that your business profits are less than the desired amount. What actions might you take to raise profits, if you do not want to change products?

ANS:

There are only a few actions that a business might take. The following are some of the possible alternatives. If the business can raise prices without hurting the sales volume in units, the contribution margin per unit would rise, resulting in higher profits. The business might consider investing in a new automated production facility, which would lower variable costs. If the increased contribution margin per unit more than offsets the increased fixed costs, profits will rise. If the business increases advertising, fixed costs will rise. If the advertising results in an increased sales volume, the increased total contribution margin may increase more than the increased fixed costs. This would result in an increase in profits.

PTS: 1 DIF: Moderate TOP: Cost-volume-profit analysis

PROBLEMS

- 1. Bob's variable costs are \$7 per unit. His selling price is \$9 per unit. His break-even point is 25 000 units.
 - a. What is the amount of Bob's fixed costs?
 - b. What is Bob's profit when he sells 30 000 units?
 - c. What would Bob's profit be if he were able to raise prices to \$10 per unit and had sales of 40 000 units?

ANS:

- a. $25\ 000 = \text{fixed costs}/(\$9 \$7)$ Fixed costs = $\$50\ 000$
- b. $(\$2 \times 30\ 000) \$50\ 000 = \$10\ 000$
- c. $(\$3 \times 40\ 000) \$50\ 000 = \$70\ 000$

DIF: Difficult

TOP: Finding the break-even point

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- 2. Following from Problem 1 above, suppose that Bob is able to make some changes to his business by increasing his selling price by \$0.50 per unit, decreasing his variable costs by \$0.50 per unit and increasing his fixed costs by \$10 000.
 - a. What is Bob's new break-even point in units?
 - b. What is Bob's profit when he sells 30 000 units?
 - c. Should Bob make the changes to his business?

ANS:

- a. BEP = Fixed costs / CM per unit = \$60 000 / (9.50 6.50) = \$60 000 / \$3 = 20 000 units
- b. $(\$3 \times 30\ 000) \$60\ 000 = \$30\ 000$
- c. Yes, he will make an additional \$20 000 of profit compared to his original situation.

PTS: 1 DIF: Difficult TOP: Finding the break-even point