Learning Objectives

LO1 Identify basic patterns of how costs respond to changes in activity cost drivers. (p. 30)
LO2 Determine a linear cost estimating equation. (p. 37)
LO3 Identify and discuss problems encountered in cost estimation. (p. 42)
LO4 Describe and develop alternative classifications for activity cost drivers. (p. 43)

To Compete on Price You Must Manage Costs

Retail giant Walmart operates more than 8,400 stores in 15 countries around the world. Its market success is built on low prices and one-stop shopping for a wide variety of goods in “discount centers” and “superstores.” Its financial success is based on optimal store and distribution center locations, technology leadership in inventory management, obtaining volume discounts from suppliers, working directly with manufacturers to obtain low-cost merchandise, and operating efficiencies. These factors allow Walmart to minimize inventory investments and maintain a high inventory turnover (cost of goods sold/average inventory). Even with relatively low prices, Walmart’s low inventory costs and high inventory turnover provide a healthy gross profit and bottom line. Walmart is an excellent example of a company successfully executing a strategy of cost leadership.

Success attracts competition and three chains of dollar stores (Family Dollar, Dollar General, and Dollar Tree) have been successfully attracting customers from Walmart by adopting Walmart’s approach to inventory management and operating efficiency, while differentiating themselves by focusing on low prices for a more limited number of high-volume items in smaller stores that provide customers more convenient access to their limited merchandise. Walmart discount centers average 108,000 square feet while its supercenters average 185,000 square feet. Dollar Tree’s 3,800+ stores average a much smaller 8,580 square feet.

While Walmart custom builds its stores, these competitors often spend less per square foot by acquiring store space originally constructed for others. This provides the dollar stores with a lower cost per square foot than Walmart, thereby allowing them to cover their building costs at a lower sales volume per square foot.

Like Walmart, the dollar stores’ key to success is high inventory turnover. And by focusing on a limited number
of high-volume inventory items, it is possible for them to achieve a higher inventory turnover than Walmart with its much broader inventory. “We can make good money on an item we sell for a dollar,” says Howard Levine, the CEO of Family Dollar. “We have 6,800 stores. If you sell one item a week in 6,800 stores, no matter what the price point, you’ve got a lot of velocity.” And that velocity is growing. Between 2007 and 2010, sales per square foot at Dollar General, which currently operates almost 9,000 stores, grew from $165 to $199. Meanwhile, during the recent recession, Walmart’s same-store sales declined.

Despite their success, the managers of dollar stores are quick to point out that they do not compete with Walmart. Instead, they claim to compete with convenience stores by offering a combination of convenience and value not available in large stores or other small convenience stores. “Walmart always worries me,” says Levine of Family Dollar. “You can’t out-Walmart Walmart. The dollar stores are not going after the same trip Walmart is going after. We are going after the fill-in trip. We live off the crumbs they leave us.”

The success of Walmart and its smaller competitors, who claim not to be competitors, is built on a cost leadership strategy. Such a strategy necessarily requires a thorough understanding of cost behavior, activity analysis, and cost estimation, the topics of this chapter.¹

COST BEHAVIOR ANALYSIS

This chapter introduces cost behavior, which refers to the relationship between a given cost item and the quantity of its related cost driver. Cost behavior, therefore, explains how the total amount for various costs respond to changes in activity volume. Understanding cost behavior is essential for estimating future costs. In this chapter we examine several typical cost behavior patterns and methods for developing cost equations that are useful for predicting future costs.

Four Basic Cost Behavior Patterns

Although there are an unlimited number of ways that costs can respond to changes in cost drivers, as a starting point it is useful to classify cost behavior into four categories: variable, fixed, mixed, and step. Graphs of each are presented in Exhibit 2.1. Observe that total cost (the dependent variable) is measured on the vertical axis, and total activity for the time period (the independent variable) is measured on the horizontal axis.

1. **Variable costs** change in total in direct proportion to changes in activity. Their total amount increases as activity increases, equaling zero dollars when activity is zero and increasing at a constant amount per unit of activity. The higher the variable cost per unit of activity, the steeper the slope of the line representing total cost. With the number of pizzas served as the cost driver for Pizza Hut restaurants, the cost of cheese is an example of a variable cost.

2. **Fixed costs** do not change in response to a change in activity volume. Hence, a line representing total fixed costs is flat with a slope (incline) of zero. With the number of Pizza Hut pizzas sold as the cost driver, annual depreciation, property taxes, and property insurance are examples of fixed costs. While fixed costs may respond to structural and organizational cost drivers over time, they do not respond to short-run changes in activity cost drivers.

3. **Mixed costs** (sometimes called semivariable costs) contain a fixed and a variable cost element. Total mixed costs are positive (like fixed costs) when activity is zero, and they increase in a linear fashion (like total variable costs) as activity increases. With the number of pizzas sold as the cost driver, the cost of electric power is an example of a mixed cost. Some electricity is required to provide basic lighting, while an increasing amount of electricity is required to prepare food as the number of pizzas served increases.

4. **Step costs** are constant within a narrow range of activity but shift to a higher level when activity exceeds the range. Total step costs increase in a steplike fashion as activity increases. With the number of pizzas served as the cost driver, employee wages is an example of a step cost. Up to a certain
number of pizzas, only a small staff needs to be on duty. Beyond that number, additional employees are needed for quality service and so forth.

The relationship between total cost \( (Y) \) axis and total activity \( (X) \) axis for the four cost behavior patterns is mathematically expressed as follows:

\[
\text{Variable cost: } Y = bX
\]

where

\( b = \text{the variable cost per unit, sometimes referred to as the slope of the cost function.} \)

\[
\text{Fixed cost: } Y = a
\]

where

\( a = \text{total fixed costs. The slope of the fixed cost function is zero because fixed costs do not change with activity.} \)

\[
\text{Mixed cost: } Y = a + bX
\]

where

\( a = \text{total fixed cost element} \)
\( b = \text{variable cost element per unit of activity.} \)

\[
\text{Step cost: } Y = a_i
\]

where

\( a_i = \text{the step cost within a specific range of activity, identified by the subscript } i. \)
The total cost function of most organizations has shifted in recent years toward more fixed costs and fewer variable costs, making it increasingly important for organizations to manage their fixed costs. Some organizations have done this by outsourcing activities rather than performing the activities internally. This avoids the many fixed costs of infrastructure in exchange for a variable cost per unit of activity. The Business Insight box below considers how an alliance between the United States Postal Service and Federal Express (FedEx) helps keep down the cost of postage by shifting fixed costs.

**BUSINESS INSIGHT** Alliance Alters USPS Cost Structure

“The Postal Service delivers Main Street, and FedEx provides an air fleet,” proclaimed the Postmaster General when announcing an alliance between the United States Postal Service (USPS) and FedEx. Under terms of the alliance, FedEx transports express mail, priority mail, and some first-class mail on its fleet of over 650 aircraft. The projected costs to the USPS are approximately $6.3 billion over the seven-year contract period. FedEx will also locate overnight service collection boxes at selected post offices across the United States.

It is predicted that the USPS will save a billion dollars in transportation costs over the life of the contract. A major aspect of the alliance is that it moves USPS from a fixed-cost transportation network toward a variable cost network. “This is a unique opportunity to turn some fixed costs into variable costs,” said the president of the Association for Postal Commerce. “It is using someone else’s fixed costs.” The chairman and chief executive officer of FedEx added that the system allows “the Postal Service to grow unconstrained without having to put in big [transportation] networks.”

**Factors Affecting Cost Behavior Patterns**

The four cost behavior patterns presented are based on the fundamental assumption that a unit of final output is the primary cost driver. The implications of this assumption are examined later in this chapter.

Another important assumption is that the time period is too short to incorporate changes in strategic cost drivers such as the scale of operations. Although this assumption is useful for short-range planning, for the purpose of developing plans for extended time periods, it is more appropriate to consider possible variations in one or more strategic cost drivers. When this is done, many costs otherwise classified as fixed are better classified as variable.

Even the cost of depreciable assets can be viewed as variable if the time period is long enough. Assuming that the number of pizzas served is the cost driver, for a single month the depreciation on all Pizza Hut restaurants in the world is a fixed cost. Over several years, if sales are strong, a strategic decision will be made to open additional restaurants; if sales are weak, strategic decisions will likely be made to close some restaurants. Hence, over a multiple-year period, the number of restaurants varies with sales volume, making depreciation appear as a variable cost with sales revenue as the cost driver.

**Total Cost Function for an Organization or Segment**

To obtain a general understanding of an organization, to compare the cost structures of different organizations, or to perform preliminary planning activities, managers are often interested in how total costs respond to a single measure of overall activity such as units sold or sales revenue. This overview can be useful, but presenting all costs as a function of a single cost driver is seldom accurate enough to support decisions concerning products, services, or activities. Doing so implies that all of an organization’s costs can be manipulated by changing a single cost driver. This is seldom true.

In developing a total cost function, the independent variable usually represents some measure of the goods or services provided customers, such as total student credit hours in a university, total sales revenue in a store, total guest-days in a hotel, or total units manufactured in a factory. The resulting cost function is illustrated in Exhibit 2.2.

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The equation for total costs is:

\[ Y = a + bX \]

where

- \( Y \) = total costs
- \( a \) = vertical axis intercept (an approximation of fixed costs)
- \( b \) = slope (an approximation of variable costs per unit of \( X \))
- \( X \) = value of independent variable

In situations where the variable, fixed, and mixed costs, and the related cost functions, can be determined, a total cost equation can be useful in predicting future costs for various activity levels. However, generally, a total cost equation is useful for predicting costs in only a limited range of activity. The relevant range of a total cost equation is that portion of the range associated with the fixed cost of the current or expected capacity. For example, assume that a Dairy Queen ice cream shop’s only fixed cost is the depreciation on its ice cream making machines, and that it is able to produce a maximum of 50 gallons of ice cream per day with a single ice cream making machine. If it has four machines in operation, and if it can readily adjust its fixed capacity cost by increasing or decreasing the number of ice cream machines, the relevant range of activity for the shop’s current total cost equation is 151 to 200 gallons. In the future, if the shop expects to operate at more than 200 gallons per day, the current total cost equation would not predict total cost accurately, because fixed costs would have to be increased for additional machines. Conversely, if it expects to operate at 150 gallons or less, it may reduce the number of machines in the shop, thereby reducing total fixed costs.

### Relevant Range

The use of straight lines in accounting models of cost behavior assumes a linear relationship between cost and activity with each additional unit of activity accompanied by a uniform increment in total cost. This uniform increment is known as the variable cost of one unit.

Economic models show a nonlinear relationship between cost and activity with each incremental unit of activity being accompanied by a varying increment in total cost. Economists identify the varying increment in total cost as the marginal cost of one unit.

It is useful to relate marginal costs to the following three levels of activity:

1. **Below the activity range for which the facility was designed**, the existence of excess capacity results in relatively high marginal costs. Having extra time, employees complete assignments at a leisurely pace, increasing the time and the cost to produce each unit above what it would be if employees were more pressed to complete work. Frequent starting and stopping of equipment may also add to costs.

2. **Within the activity range for which the facility was designed**, activities take place under optimal circumstances and marginal costs are relatively low.
3. *Above the activity range for which the facility was designed*, the existence of capacity constraints again results in relatively high marginal costs. Near capacity, employees may be paid overtime wages, less-experienced employees may be used, regular equipment may operate less efficiently, and old equipment with high energy requirements may be placed in service.

Based on marginal cost concepts, the economists’ short-run total cost function is illustrated in the first graph in Exhibit 2.3. The vertical axis intercept represents capacity costs. Corresponding to the high marginal costs at low levels of activity, the initial slope is quite steep. In the normal activity range, where marginal costs are relatively low, the slope becomes less steep. Then, corresponding to high marginal costs above the normal activity range, the slope of the economists’ total cost function increases again.

![EXHIBIT 2.3 Economic and Accounting Cost Structures](image)

If the economists’ total cost curve is valid, how can we reasonably approximate it with a straight line? The answer to this question is in the notion of a *relevant range*. A linear pattern may be a poor approximation of the economists’ curvilinear pattern over the entire range of possible activity, but a

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**RESEARCH INSIGHT** **Don’t Base Decision Only on the Purchase Price**

When buying a printer, it is tempting to base the decision on the purchase price of the printer, or on the price of the printer and the cost of replacement cartridges. That would be a mistake according to David Stone who analyzed the yield on ink cartridges and the three-year cost of operating and owning printers with recommended ink cartridges under light- and heavy-duty operation for general printing.

The first step in Stone’s analysis was determining the average cost of a standard printed page using ink cartridges recommended for five widely used printers. The low-cost winner for printing in black was the HP Officejet K5400dtn Color printer using the HP 74XL black cartridge at 1.4 cents per page ($34.99 cost of cartridge divided by the average yield of 2,450 pages per cartridge). With three additional cartridges required for color printing, the HP Officejet K5400dtn Color printer was also the low-cost color printer at 5.9 cents per page. For color printing, the Kodak EasyShare 5300 All-in-One, with the advantage of only requiring one color ink cartridge, came in second at 6.9 cents per page.

Looking at three-year total ownership costs with light-duty general printing, the Lexmark X3550 was the low-cost leader. Although the per page costs of cartridges used in the Lexmark X3550 was higher than either the HP Officejet K5400dtn or the Kodak EasyShare 5300, the low purchase price of the Lexmark X3550 gave it the lowest three-year total cost for light-duty printing. For heavy-duty general printing, the HP Officejet K5400dtn or the Kodak EasyShare 5300 took top honors with three-year costs of $562.20 and $657.19, respectively.

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linear pattern as illustrated in the right-hand graph in Exhibit 2.3 is often sufficiently accurate within the range of probable operations. The range of activity within which a linear cost function is valid is called the relevant range. Linear estimates of cost behavior are valid only within the relevant range. Extreme care must be exercised when making comments about cost behavior outside the relevant range.

**Additional Cost Behavior Patterns**

Although we have considered the most frequently used cost behavior patterns, remember that there are numerous ways that costs can respond to changes in activity. Avoid the temptation to automatically assume that the cost in question conforms to one of the patterns discussed in this chapter. As illustrated by the Research Insight box on the following page, it is important to think through each situation and then select a behavior pattern that seems logical and fits the known facts.

Particular care needs to be taken with the vertical axis. So far, all graphs have placed total costs on the vertical axis. Miscommunication is likely if one party is thinking in terms of total costs while the other is thinking in terms of variable or average costs. Consider the following cost function:

$$\text{Total costs} = 3,000 + 5X$$

where

$$X = \text{customers served}$$

The total, variable, and average costs at various levels of activity are computed here and graphed in Exhibit 2.4 on the following page. As the number of customers served increases, total costs increase, the variable costs of each unit remain constant, and the average cost decreases because fixed costs are spread over a larger number of units.

<table>
<thead>
<tr>
<th>Customers Served</th>
<th>Total Costs</th>
<th>Average Cost*</th>
<th>Variable Costs per Customer</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>3,500</td>
<td>35.00</td>
<td>5.00</td>
</tr>
<tr>
<td>200</td>
<td>4,000</td>
<td>20.00</td>
<td>5.00</td>
</tr>
<tr>
<td>300</td>
<td>4,500</td>
<td>15.00</td>
<td>5.00</td>
</tr>
<tr>
<td>400</td>
<td>5,000</td>
<td>12.50</td>
<td>5.00</td>
</tr>
<tr>
<td>500</td>
<td>5,500</td>
<td>11.00</td>
<td>5.00</td>
</tr>
</tbody>
</table>

* Total costs/customers served

To predict total costs for the coming period, management will use the first graph in Exhibit 2.4. To determine the minimum price required to avoid a loss on each additional customer served, management is interested in the variable costs per customer, yet if a manager inquired as to the cost of serving a customer, a financial accountant would probably provide average cost information, as illustrated in the third graph in Exhibit 2.4. The specific average cost would likely be a function of the number of customers served during the most recent accounting period.

Errors can occur if last period’s average costs, perhaps based on a volume of 500 customers, were used to predict total costs for a future period when the anticipated volume was some other amount, say 300 units. Using average costs, the predicted total costs of 300 units are $3,300 ($11 \times 300). In fact, using the proper total cost function, a more accurate prediction of total costs is $4,500 ($3,000 + ($5 \times 300)). The prediction error could cause a number of problems. If management budgeted $3,300 to pay bills and the bills actually totaled $4,500, the company might have to curtail activities or borrow under unfavorable terms to avoid running out of cash.

**Committed and Discretionary Fixed Costs**

Fixed costs are often classified as committed or discretionary, depending on their immediate impact on the organization if management attempts to change them. Committed fixed costs, sometimes referred to as capacity costs, are the fixed costs required to maintain the current service or production capacity or to fill previous legal commitments. Examples of committed fixed costs include depreciation, property taxes, rent, and interest on bonds.
Committed fixed costs are often the result of structural decisions about the size and nature of an organization. For example, years ago the management of Santa Fe Railroad made decisions concerning what communities the railroad would serve. Track was laid on the basis of those decisions, and the Santa Fe Railroad now pays property taxes each year on the railroad’s miles of track. These property taxes could be reduced by disposing of track. However, reducing track would also diminish the Santa Fe’s capacity to serve.

Discretionary fixed costs, sometimes called managed fixed costs, are set at a fixed amount each period at the discretion of management. It is possible to reduce discretionary fixed costs without reducing production or service capacity in the short term. Typical discretionary fixed costs include advertising, maintenance, charitable contributions, employee training, and research and development.

Maintenance expenditures for discretionary fixed costs are frequently regarded as investments in the future. Research and development, for example, is undertaken to develop new or improved products that can be profitably produced and sold in future periods. During periods of financial well-being, organizations may make large expenditures on discretionary cost items. Conversely, during periods of financial stress, organizations likely reduce discretionary expenditures before reducing capacity costs.
Unfortunately, fluctuations in the funding of discretionary fixed costs may reduce the effectiveness of long-range programs. A high-quality research staff may be difficult to reassemble if key personnel are laid off. Even the contemplation of layoffs may reduce the staff’s effectiveness. In all periods, discretionary costs are subject to debate and are likely to be changed in the budgeting process.

**MID-CHAPTER REVIEW**

Identify each of the following cost behavior patterns as variable, committed fixed, discretionary fixed, mixed, or step.

- **a.** Total cost of bakery products used at a McDonald’s restaurant when the number of meals served is the activity cost driver.
- **b.** Total cost of operating the Mayo Clinic when the number of patients served is the cost driver.
- **c.** Total property taxes for a Midas Muffler Shop when the number of vehicles serviced is the cost driver.
- **d.** Total cost of motherboards used by Apple Computer when the number of computers manufactured and shipped is the cost driver.
- **e.** Total cost of secretarial services at Indiana University with each secretary handling the needs of ten faculty members and where part-time secretarial help is not available. The number of faculty is the cost driver.
- **f.** Total advertising costs for International Business Machines (IBM).
- **g.** Automobile rental costs at Alamo in Orlando, Florida, when there is no mileage charge. The cost driver is the number of miles driven.
- **h.** Automobile rental cost at Hertz in Dallas, Texas, which has a base charge plus a mileage charge. The cost driver is the number of miles driven.
- **i.** Salaries paid to personnel while conducting on-campus employment interviews for Champion International. Number of on-campus interviews is the cost driver.
- **j.** The cost of contributions to educational institutions by Xerox Corporation.

**Solution**

- **a.** Variable cost
- **b.** Mixed cost
- **c.** Committed fixed cost
- **d.** Variable cost
- **e.** Step cost
- **f.** Discretionary fixed cost
- **g.** Fixed cost (Without knowing the purpose of renting the car, the cost cannot be classified as committed or discretionary.)
- **h.** Mixed cost
- **i.** Step cost
- **j.** Discretionary fixed cost

**COST ESTIMATION**

Cost estimation, the determination of the relationship between activity and cost, is an important part of cost management. In this section, we develop equations for the relationship between total costs and total activity.

To properly estimate the relationship between activity and cost, we must be familiar with basic cost behavior patterns and cost estimating techniques. Costs known to have a variable or a fixed pattern are readily estimated by interviews or by analyzing available records. Sales commission per sales dollar, a variable cost, might be determined to be 15 percent of sales. In a similar manner, annual property taxes might be determined by consulting tax documents.

Mixed (semivariable) costs, which contain fixed and variable cost elements, are more difficult to estimate. According to a basic rule of algebra, two equations are needed to determine two unknowns. Following this rule, at least two observations are needed to determine the variable and fixed elements of a mixed cost.
High-Low Cost Estimation

The most straightforward approach to determining the variable and fixed elements of mixed costs is to use the **high-low method of cost estimation**. This method utilizes data from two time periods, a representative high-activity period and a representative low-activity period, to estimate fixed and variable costs. Assuming identical fixed costs in both periods, any difference in total costs between these two periods is due entirely to variable costs. The variable costs per unit are found by dividing the difference in total costs by the difference in total activity:

\[
\text{Variable costs per unit} = \frac{\text{Difference in total costs}}{\text{Difference in activity}}
\]

Once variable costs are determined, fixed costs, which are identical in both periods, are computed by subtracting the total variable costs of either the high or the low activity period from the corresponding total costs.

\[
\text{Fixed costs} = \text{Total costs} - \text{Variable costs}
\]

Assume a mail-order company such as **Lands’ End** wants to develop a monthly cost function for its packaging department and that the number of shipments is believed to be the primary cost driver. The following observations are available for the first four months of 2011.

<table>
<thead>
<tr>
<th>Number of Shipments</th>
<th>Packaging Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Low-activity period)</td>
<td></td>
</tr>
<tr>
<td>January ..........</td>
<td>6,000 ..........</td>
</tr>
<tr>
<td>February ..........</td>
<td>9,000 ..........</td>
</tr>
<tr>
<td>(High-activity period)</td>
<td></td>
</tr>
<tr>
<td>March ..........</td>
<td>12,000 ..........</td>
</tr>
<tr>
<td>April ..........</td>
<td>10,000 ..........</td>
</tr>
</tbody>
</table>

Equations for total costs for the packaging department in January and March (the periods of lowest and highest activity) follow:

\[
\begin{align*}
\text{January:} & \quad \$17,000 = a + b (6,000 \text{ shipments}) \\
\text{March:} & \quad \$32,000 = a + b (12,000 \text{ shipments})
\end{align*}
\]

where

\[
\begin{align*}
a & = \text{fixed costs per month} \\
b & = \text{variable costs per shipment}
\end{align*}
\]

Solving for the estimated variable costs:

\[
b = \frac{\text{Difference in total costs}}{\text{Difference in activity}} = \frac{\$32,000 - \$17,000}{12,000 - 6,000} = \$2.50
\]

Next, the estimated monthly fixed costs are determined by subtracting variable costs from total costs of either the January or March equation:

\[
\begin{align*}
a & = \text{Total costs} - \text{Variable costs} \\
\text{January:} & \quad a = \$17,000 - (\$2.50 \text{ per shipment} \times 6,000 \text{ shipments}) = \$2,000 \\
\text{March:} & \quad a = \$32,000 - (\$2.50 \text{ per shipment} \times 12,000 \text{ shipments}) = \$2,000
\end{align*}
\]
The cost estimating equation for total packaging department costs is

\[ Y = 2000 + 2.50X \]

where

\[ X = \text{number of shipments} \]

\[ Y = \text{total costs for the packing department} \]

The concepts underlying the high-low method of cost estimation are illustrated in Exhibit 2.5.

Cost prediction, the forecasting of future costs, is a common purpose of cost estimation. Previously developed estimates of cost behavior are often the starting point in predicting future costs. Continuing the mail-order example, if 5,000 shipments are budgeted for June 2011, the predicted June 2011 packaging department costs are $14,500 [$2,000 + ($2.50 per shipment \times 5,000 shipments)].

Scatter Diagrams

A scatter diagram is a graph of past activity and cost data, with individual observations represented by dots. Plotting historical cost data on a scatter diagram is a useful approach to cost estimation, especially when used in conjunction with other cost-estimating techniques. As illustrated in Exhibit 2.6, a scatter diagram helps in selecting high and low activity levels representative of normal operating conditions. The periods of highest or lowest activity may not be representative because of the cost of overtime, the use of less efficient equipment, strikes, and so forth. If the goal is to develop an equation to predict costs under normal operating conditions, then the equation should be based on observations of normal operating conditions. A scatter diagram is also useful in determining whether costs can be reasonably approximated by a straight line.

Scatter diagrams are sometimes used alone as a basis of cost estimation. This requires the use of professional judgment to draw a representative straight line through the plot of historical data. Typically, the
analyst tries to ensure that an equal number of observations are on either side of the line while minimizing the total vertical differences between the line and actual cost observations at each value of the independent variable. Once a line is drawn, cost estimates at any representative volume are made by studying the line. Alternatively, an equation for the line may be developed by applying the high-low method to any two points on the line.

**Least-Squares Regression**

*Least-squares regression analysis* uses a mathematical technique to fit a cost-estimating equation to the observed data. The technique mathematically accomplishes what the analyst does visually with a scatter diagram. The least-squares technique creates an equation that minimizes the sum of the vertical squared differences between the estimated and the actual costs at each observation. Each of these differences is an estimating error. Using the packaging department example, the least-squares criterion is illustrated in Exhibit 2.7. Estimated values of total monthly packaging costs are represented by the straight line, and the actual values of total monthly packaging costs are represented by the dots. For each dot, such as the one at a volume of 10,000 shipments, the line is fit to minimize the vertical squared differences.

**EXHIBIT 2.7  Least-Squares Criterion**

Values of $a$ and $b$ can be manually calculated using a set of equations developed by mathematicians or by using spreadsheet software packages such as Microsoft Excel®. Many calculators also have built-in functions to compute these coefficients. The least-squares equation for monthly packaging costs is:

$$Y = 3,400 + 2.20X$$

Using the least-squares equation, the predicted June 2011 packaging department costs with 5,000 budgeted shipments are $14,400 [$3,400 + ($2.20 per shipment $\times$ 5,000 shipments)]. Recall that the high-low method predicted June 2011 costs of $14,500. Although this difference is small, we should consider which prediction is more reliable.

**Advantage of Least-Squares Regression**

Mathematicians regard least-squares regression analysis as superior to both the high-low and the scatter diagram methods. It uses all available data, rather than just two observations, and does not rely on subjective judgment in drawing a line. Statistical measures are also available to determine how well a least-squares equation fits the historical data. These measures are often contained in the output of spreadsheet software packages.

In addition to the vertical axis intercept and the slope, least-squares regression calculates the coefficient of determination. The *coefficient of determination* is a measure of the percent of variation in the dependent variable (such as total packaging department costs) that is explained by variations...
in the independent variable (such as total shipments). Statisticians often refer to the coefficient of
determination as R-squared and represent it as $R^2$.

The coefficient of determination can have values between zero and one, with values close to zero
suggesting that the equation is not very useful and values close to one indicating that the equation
explains most of the variation in the dependent variable. When choosing between two cost-estimating
equations, the one with the higher coefficient of determination is generally preferred. The coefficient of
determination for the packaging department cost estimation equation, determined using least-squares
regression analysis, is 0.68. This means that 68 percent of the variation in packaging department costs
is explained by the number of shipments.

**Managers, Not Models, Are Responsible**

Although computers make least-squares regression easy to use, the generated output should not auto-
matically be accepted as correct. Statistics and other mathematical techniques are tools to help man-
agers make decisions. Managers, not mathematical models, are responsible for decisions. Judgment
should always be exercised when considering the validity of the least-squares approach, the solution,
and the data. If the objective is to predict future costs under normal operating conditions, observations
reflecting abnormal operating conditions should be deleted. Also examine the cost behavior pattern to
determine whether it is linear. Scatter diagrams assist in both of these judgments. Finally, the results
should make sense. When the relationships between total cost and several activity drivers are exam-
ined, it is possible to have a high R-squared purely by chance. Even though the relationship has a high
R-squared, if it “doesn’t make sense” there is probably something wrong.

**Simple and Multiple Regression**

Least-squares regression analysis is identified as “simple regression analysis” when there is only one
independent variable and as “multiple regression analysis” when there are two or more independent
variables. The general form for simple regression analysis is:

$$ Y = a + bX $$

The general form for multiple regression analysis is:

$$ Y = a + \Sigma b_i X_i $$

In this case, the subscript $i$ is a general representation of each independent variable. When there are
several independent variables, $i$ is set equal to 1 for the first, 2 for the second, and so forth. The total
variable costs of each independent variable is computed as $b_i X_i$, with $b_i$ representing the variable cost
per unit of independent variable $X_i$. The Greek symbol sigma, $\Sigma$, indicates that the costs of all indepen-
dent variables are summed in determining total variable costs.

As an illustration, assume that Walnut Desk Company’s costs are expressed as a function of the
unit sales of its two products: executive desks and task desks. Fixed costs are $18,000 per month and
the variable costs are $250 per executive desk and $120 per task desk. The mathematical representation
of monthly costs with two variables is:

$$ Y = a + b_1 X_1 + b_2 X_2 $$

where

$$ a = $18,000 $$
$$ b_1 = $250 $$
$$ b_2 = $120 $$
$$ X_1 = \text{unit sales of executive desks} $$
$$ X_2 = \text{unit sales of task desks} $$
During a month when 105 executive desks and 200 task desks are sold, Walnut Desk Company’s estimated total costs are:

\[ Y = 18,000 + 250(105) + 120(200) \]
\[ = 68,250 \]

In addition to estimating costs, multiple regression analysis can be used to determine the effect of individual product features on the market value of a product or service. The following Research Insight reports on a low-cost approach, using a model similar to multiple regression analysis to predict future health and life expectancy.

**RESEARCH INSIGHT**

**Is Social Data a Cost Effective and Acceptable Predictor of Health?**

According to the insurance industry, the underwriting costs of issuing a life insurance policy range up to $1,000, with a significant portion spent on medical tests and exams. Using information on 60,000 insurance applicants gathered by data-assembly and mining firms, Deloitte Consulting LLP has developed a model that predicts a person’s risk for diseases (and life expectancy) related to lifestyle. The information is gathered from a variety of sources including: public records, surveys, online behavior such as surfing and purchases, and social networking sites. Independent variables in the model include: activity indicators, financial indicators, purchases related to health or obesity, and television consumption. Although Deloitte estimates insurers could save an average of $125 per applicant by using the model, insurance companies are concerned that efforts to use the model for decision making will likely raise a number of privacy issues and objections from state insurance commissions.4

**MANAGERIAL DECISION**

**You are the Purchasing Manager**

Your department has been experiencing increased activity in recent periods as the company has grown, and you have observed that the average cost per purchase order processed has been declining, but not at a constant rate. You have been given an estimate by the production manager of the number of purchase orders that will be processed next period and have been asked by the accounting department to provide within one hour an estimate of the cost to process those orders. How can the scatter diagram method help you to meet this deadline? [Answer, p. 48]

**ADDITIONAL ISSUES IN COST ESTIMATION**

We have mentioned several items to be wary of when developing cost estimating equations:

- Data that are not based on normal operating conditions.
- Nonlinear relationships between total costs and activity.
- Obtaining a high R-squared purely by chance.

Additional items of concern include:

- Changes in technology or prices.
- Matching activity and cost within each observation.
- Identifying activity cost drivers.

**Changes in Technology and Prices**

Changes in technology and prices make cost estimation and prediction difficult. When telephone companies changed from using human operators to using automated switching equipment to place long-distance telephone calls, cost estimates based on the use of human operators were of little or no value in predicting future costs. Care must be taken to make sure that data used in developing cost estimates are based on the existing technology. When this is not possible, professional judgment is required to make appropriate adjustments.

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Only data reflecting a single price level should be used in cost estimation and prediction. If prices have remained stable in the past but then uniformly increase by 20 percent, cost-estimating equations based on data from previous periods will not accurately predict future costs. In this case, all that is required is a 20 percent increase in the prediction. Unfortunately, adjustments for price changes are seldom this simple. The prices of various cost elements are likely to change at different rates and at different times. Furthermore, there are probably several different price levels included in the past data used to develop cost-estimating equations. If data from different price levels are used, an attempt should be made to restate them to a single price level.

Matching Activity and Costs

The development of accurate cost-estimating equations requires the matching of the activity to related costs within each observation. This accuracy is often difficult to achieve because of the time lag between an activity and the recording of the cost of resources consumed by the activity. Current activities usually consume electricity, but the electric bill won’t be received and recorded until next month. Driving an automobile requires routine maintenance for items such as lubrication and oil, but the auto can be driven several weeks or even months before the maintenance is required. Consequently, daily, weekly, and perhaps even monthly observations of miles driven and maintenance costs are unlikely to match the costs of oil and lubrication with the cost-driving activity, miles driven.

In general, the shorter the time period, the higher the probability of error in matching costs and activity. The cost analyst must carefully review the database to verify that activity and cost are matched within each observation. If matching problems are found, it may be possible to adjust the data (perhaps by moving the cost of electricity from one observation to another). Under other circumstances, it may be necessary to use longer periods to match costs and activity.

Identifying Activity Cost Drivers

Identifying the appropriate activity cost driver for a particular cost requires judgment and professional experience. In general, the cost driver should have a logical, causal relationship with costs. In many cases, the identity of the most appropriate activity cost driver, such as miles driven for the cost of automobile gasoline, is apparent. In other situations, where different activity cost drivers might be used, scatter diagrams and statistical measures, such as the coefficient of determination, are helpful in selecting the activity cost driver that best explains past variations in cost. When scatter diagrams are used, the analyst can study the dispersion of observations around the cost-estimating line. In general, a small dispersion is preferred. If regression analysis is used, the analyst considers the coefficient of determination. In general, a higher coefficient of determination is preferred. The relationship between the activity cost driver and the cost must seem logical, and the activity data must be available.

ALTERNATIVE COST DRIVER CLASSIFICATIONS

So far we have examined cost behavior and cost estimation using only a unit-level approach, which assumes changes in costs are best explained by changes in the number of units of product or service provided customers. This approach may have worked for Carnegie Steel Company, but it is inappropriate for multiproduct organizations, such as General Electric. The unit-level approach becomes increasingly inaccurate for analyzing cost behavior when organizations experience the following types of changes:

■ From labor-based to automated manufacturing,

■ From a limited number of related products to multiple products, with variations in product volume and complexity (and related costs), and

■ From a set of similar customers to a diverse set of customers.

Exhibit 2.8 illustrates the composition of total manufacturing costs for the past century, illustrating changes in the percentage of manufacturing costs for three major cost categories.

LO4 Describe and develop alternative classifications for activity cost drivers.
EXHIBIT 2.8  Changing Composition of Total Manufacturing Costs

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct materials have increased</th>
<th>Manufacturing overhead has increased</th>
<th>Direct labor has decreased</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>0%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>1950</td>
<td>1900</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>1950</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

1. **Direct materials**, the cost of primary raw materials converted into finished goods, have increased slightly as organizations purchase components they formerly fabricated. The word “direct” is used to indicate costs that are easily or directly traced to a finished product or service.

2. **Direct labor**, the wages earned by production employees for the time they spend converting raw materials into finished products, has decreased significantly as employees spend less time physically working on products and more time supporting automated production activities.

3. **Manufacturing overhead**, which includes all manufacturing costs other than direct materials and direct labor, has increased significantly due to automation, product diversity, and product complexity.

Changes in the composition of manufacturing costs have implications for the behavior of total costs and the responsiveness of costs to changes in cost drivers. Because direct materials and direct labor vary directly with the number of units, they are easy to measure. In the past, when manufacturing overhead was relatively small, it was possible to assume units of product or service was the primary cost driver. This is no longer true. Units of final product is no longer an adequate explanation of changes in manufacturing overhead for many organizations.

The past tendency to ignore overhead, while focusing on direct materials and direct labor, led one researcher to describe overhead-causing activities as “the hidden factory.” To better understand the hidden factory, several researchers have developed frameworks for categorizing cost-driving activities. The crucial feature of these frameworks is the inclusion of nonunit cost drivers. Depending on the characteristics of a particular organization, as well as management’s information needs, there are an almost unlimited number of cost driver classification schemes. We consider two frequently applied cost driver classification schemes: one based on a manufacturing cost hierarchy and a second based on a customer cost hierarchy. We also illustrate variations of each.

**Manufacturing Cost Hierarchy**

The most well-known framework, developed by Cooper and Cooper and Kaplan for manufacturing situations, classifies activities into the following four categories.

1. A **unit-level activity** is performed for each unit of product produced. **Oneida Silversmiths** manufactures high-quality eating utensils. In the production of forks, the stamping of each fork into the prescribed shape is an example of a unit-level cost driver.

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2. A batch-level activity is performed for each batch of product produced. At Oneida Silversmiths, a batch is a number of identical units (such as a fork of a specific design) produced at the same time. Batch-level activities include setting up the machines to stamp each fork in an identical manner, moving the entire batch between workstations (i.e., molding, stamping, and finishing), and inspecting the first unit in the batch to verify that the machines are set up correctly.

3. A product-level activity is performed to support the production of each different type of product. At Oneida Silversmiths, product-level activities for a specific pattern of fork include initially designing the fork, producing and maintaining the mold for the fork, and determining manufacturing operations for the fork.

4. A facility-level activity is performed to maintain general manufacturing capabilities. At Oneida Silversmiths, facility-level activities include plant management, building maintenance, property taxes, and electricity required to sustain the building.

Several additional examples of the costs driven by activities at each level are presented in Exhibit 2.9.

<table>
<thead>
<tr>
<th>Activity Level</th>
<th>Reason for Activity</th>
<th>Examples of Activity Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Unit level</td>
<td>Performed for each unit of product produced or sold</td>
<td>• Cost of raw materials</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of inserting a component</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Utilities cost of operating equipment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Some costs of packaging</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Sales commissions</td>
</tr>
<tr>
<td>2. Batch level</td>
<td>Performed for each batch of product produced or sold</td>
<td>• Cost of processing sales order</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of issuing and tracking work order</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of equipment setup</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of moving batch between workstations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of inspection (assuming same number of units inspected in each batch)</td>
</tr>
<tr>
<td>3. Product level</td>
<td>Performed to support each different product that can be produced</td>
<td>• Cost of product development</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of product marketing such as advertising</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of specialized equipment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of maintaining specialized equipment</td>
</tr>
<tr>
<td>4. Facility level</td>
<td>Performed to maintain general manufacturing capabilities</td>
<td>• Cost of maintaining general facilities such as buildings and grounds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of nonspecialized equipment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of maintaining nonspecialized equipment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of real property taxes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of general advertising</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost of general administration such as the plant manager’s salary</td>
</tr>
</tbody>
</table>

When using a cost hierarchy for analyzing and estimating costs, total costs are broken down into the different cost levels in the hierarchy, and a separate cost driver is determined for each level of cost. For example, using the above hierarchy, the costs that are related to the number of units produced (such as direct materials or direct labor) may have direct labor hours or machines hours as the cost driver; whereas, batch costs may be driven by the number of setups of production machines or the number of times materials are move from one machine to another. Other costs may be driven by the number of different products produced. Facility-level costs are generally regarded as fixed costs and do not vary unless capacity is increased or decreased.

**Customer Cost Hierarchy**

The manufacturing hierarchy presented is but one of many possible ways of classifying activities and their costs. Classification schemes should be designed to fit the organization and meet user needs. A merchandising organization or the sales division of a manufacturing organization might use the following hierarchy.
1. Unit-level activity: performed for each unit sold.
2. Order-level activity: performed for each sales order.
3. Customer-level activity: performed to obtain or maintain each customer.
4. Facility-level activity: performed to maintain the general marketing function

This classification scheme assists in answering questions concerning the cost of individual orders or individual customers.

If an organization sells to distinct market segments (for profit, not for profit, and government), the cost hierarchy can be modified as follows:

1. Unit-level activity
2. Order-level activity
3. Customer-level activity
4. Market-segment-level activity: performed to obtain or maintain operations in a segment.
5. Facility-level activity

The market-segment-level activities and their related costs differ with each market segment. This classification scheme assists in answering questions concerning the profitability of each segment.

Finally, an organization that completes unique projects for different market segments (such as buildings for IBM and the U.S. Department of Defense) can use the following hierarchy to determine the profitability of each segment:

1. Project-level activity: performed to support the completion of each project.
2. Market-segment-level activity
3. Facility-level activity

The possibilities are endless. The important point is that both the cost hierarchy and the costs included in the hierarchy be tailored to meet the specific circumstances of an organization and the interests of management. The following Business Insight box considers a possible cost hierarchy for the airline industry, with a closer examination of aircraft types as a cost driver.

**BUSINESS INSIGHT** Aircraft Diversity is a Cost Driver

Cost hierarchies can be developed for almost any type of organization. The cost hierarchy for airlines might include seat miles, airports served, number of flights, point-to-point or hub and spoke scheduling, age of aircraft, and number of aircraft types. The diversity of aircraft impacts costs such as maintenance, parts inventories, ability to substitute aircraft and crew on a scheduled flight, pilot training, and crew assignments. Consider the differences between US Airways and AirTran in fleet complexity.

US Airways, formed through a series of mergers (the latest with America West), flies a wide variety of regional, national, and international routes. Because of its history of mergers and complex route structure, US Airways operates more than 450 aircraft consisting of 15 types, ranging from the De Havilland Dash 8-100 with 37 seats to the Airbus A330-300 with 266 seats. Although US Airways is striving to reduce the diversity of its fleet, which has been called a “hodgepodge,” restructuring fixed assets takes many years. In the interim, US Airways struggles with high costs related to the number of aircraft types.

AirTran operates approximately 130 aircraft consisting of only two types, Boeing B717 and B737, from a single manufacturer. AirTran was the launch customer for the B717 that management regards as “ideally suited for the short-hall, high-frequency service that we primarily operate.” Explaining the addition of the B737 to AirTran’s fleet, management noted that Boeing discontinued the production of the B717 in 2006. By focusing on two types of Boeing aircraft, AirTran benefits from many efficiencies and avoids the types of costs US Airways incurs by having so many different types of planes.8

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CHAPTER-END REVIEW

Assume a local Subway reported the following results for April and May:

<table>
<thead>
<tr>
<th></th>
<th>April</th>
<th>May</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit sales</td>
<td>2,100</td>
<td>2,700</td>
</tr>
<tr>
<td>Cost of food sold</td>
<td>$1,575</td>
<td>$2,025</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>1,525</td>
<td>1,675</td>
</tr>
<tr>
<td>Rent on building</td>
<td>1,500</td>
<td>1,500</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Utilities</td>
<td>710</td>
<td>770</td>
</tr>
<tr>
<td>Supplies</td>
<td>225</td>
<td>255</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>113</td>
<td>131</td>
</tr>
<tr>
<td>Total</td>
<td>$5,848</td>
<td>$6,556</td>
</tr>
</tbody>
</table>

Required

a. Identify each cost as being fixed, variable, or mixed.
b. Using the high-low method, estimate an equation for the cost of food, wages and salaries, rent on building, and total monthly costs.
c. Predict total costs for monthly volumes of 1,000 and 2,000 units.
d. Predict the average cost per unit at monthly volumes of 1,000 and 2,000 units. Explain why the average costs differ at these two volumes.

Solution

a. Fixed costs are easily identified. They are the same at each activity level. Variable and mixed costs are determined by dividing the total costs for an item at two activity levels by the corresponding units of activity. The quotients of the variable cost items will be identical at both activity levels. The quotients of the mixed costs will differ, being lower at the higher activity level because the fixed costs are being spread over a larger number of units.

<table>
<thead>
<tr>
<th>Cost</th>
<th>Behavior</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of food sold</td>
<td>Variable</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>Mixed</td>
</tr>
<tr>
<td>Rent on building</td>
<td>Fixed</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>Fixed</td>
</tr>
<tr>
<td>Utilities</td>
<td>Mixed</td>
</tr>
<tr>
<td>Supplies</td>
<td>Mixed</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Mixed</td>
</tr>
</tbody>
</table>

b. The cost of food sold was classified as a variable cost. Hence, the cost of food may be determined by dividing the total costs at either observation by the corresponding number of units.

\[ b = \frac{\$1,575 \text{ total variable costs}}{2,100 \text{ units}} = \$0.75X \]

Wages and salaries were previously classified as a mixed cost. Hence, the cost of wages and salaries is determined using the high-low method.

\[ (\text{variable cost}) \quad b = \frac{\$1,675 - \$1,525}{2,700 - 2,100} = 0.25X \]

\[ (\text{fixed cost}) \quad a = \$1,525 \text{ total cost} - (0.25 \times 2,100) \text{ variable cost} = \$1,000 \]

Rent on building was classified as a fixed cost.

\[ a = \$1,500 \]
Total monthly costs most likely follow a mixed cost behavior pattern. Hence, they can be determined using the high-low method.

\[
b = \frac{6,556 - 5,848}{2,700 - 2,100} = \$1.18X
\]

\[
a = 5,848 - (1.18 \times 2,100) = \$3,370
\]

Total costs = \(a + bX\)

where

\[
X = \text{unit sales}
\]

c. and d.

<table>
<thead>
<tr>
<th>Volume</th>
<th>Total Costs</th>
<th>Average Cost per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000</td>
<td>$3,370 + (1.18 \times 1,000) = $4,550</td>
<td>$4,550/1,000 = $4.550</td>
</tr>
<tr>
<td>2,000</td>
<td>$3,370 + (1.18 \times 2,000) = $5,730</td>
<td>$5,730/2,000 = $2.865</td>
</tr>
</tbody>
</table>

The average costs differ at 1,000 and 2,000 units because the fixed costs are being spread over a different number of units. The larger the number of units, the smaller the average fixed cost per unit.

**GUIDANCE ANSWER**

**MANAGERIAL DECISION** You are the Purchasing Manager

One of the quickest methods for gaining a general understanding of the relationship between a given cost and its cost driver is to graph the relationship using data from several recent periods. As purchasing manager you could probably quickly obtain information about the amount of the total purchasing department costs and number of purchase orders processed for each of the most recent eight or ten periods. By graphing these data with costs on the vertical axis and number of purchase orders on the horizontal axis, you should be able to visually determine if there is an obvious behavioral pattern (variable, fixed, or mixed). Since costs have been declining as volume has increased, this would suggest that there are some fixed costs, and that they have been declining on a per unit basis as they are spread over an increasing number of purchase orders. Using two representative data points in the scatter diagram, you can plot a cost curve on the graph, and then use the data for those two points to calculate the estimated fixed and variable costs using the high-low cost estimation method. Using these cost estimates, you can predict the total cost for next period. This method may not give you a precise estimate of the cost, but coupled with your subjective estimate of cost based on your experience as manager of the department, it should give you more confidence than merely making a best guess. Hopefully, you will have an opportunity before presenting your budget for the next period to conduct additional analyses using more advanced methods.

**DISCUSSION QUESTIONS**

Q2-1. Briefly describe variable, fixed, mixed, and step costs and indicate how the total cost function of each changes as activity increases within a time period.

Q2-2. Why is presenting all costs of an organization as a function of a single independent variable, although useful in obtaining a general understanding of cost behavior, often not accurate enough to make specific decisions concerning products, services, or activities?

Q2-3. Explain the term “relevant range” and why it is important in estimating total costs.

Q2-4. How are variable and fixed costs determined using the high-low method of cost estimation?

Q2-5. Distinguish between cost estimation and cost prediction.

Q2-6. Why is a scatter diagram helpful when used in conjunction with other methods of cost estimation?

Q2-7. Identify two advantages of least-squares regression analysis as a cost estimation technique.

Q2-8. Why is it important to match activity and costs within a single observation? When is this matching problem most likely to exist?

Q2-9. During the past century, how have direct materials, direct labor, and manufacturing overhead changed as a portion of total manufacturing costs? What is the implication of the change in manufacturing overhead for cost estimation?
Q2-10. Distinguish between the unit-, batch-, product-, and facility-level activities of a manufacturing organization.

**MINI EXERCISES**

M2-11. Classifying Cost Behavior  **(LO1)**

Classify the total costs of each of the following as variable, fixed, mixed, or step. Sales volume is the cost driver.

- a. Salary of the department manager
- b. Memory chips in a computer assembly plant
- c. Real estate taxes
- d. Salaries of quality inspectors when each inspector can evaluate a maximum of 1,000 units per day
- e. Wages paid to production employees for the time spent working on products
- f. Electric power in a factory
- g. Raw materials used in production
- h. Automobiles rented on the basis of a fixed charge per day plus an additional charge per mile driven
- i. Sales commissions
- j. Depreciation on office equipment

M2-12. Classifying Cost Behavior  **(LO1)**

Classify the total costs of each of the following as variable, fixed, mixed, or step.

- a. Straight-line depreciation on a building
- b. Maintenance costs at a hospital
- c. Rent on a photocopy machine charged as a fixed amount per month plus an additional charge per copy
- d. Cost of goods sold in a bookstore
- e. Salaries paid to temporary instructors in a college as the number of course sessions varies
- f. Lumber used by a house construction company
- g. The costs of operating a research department
- h. The cost of hiring a dance band for three hours
- i. Laser printer paper for a department printer
- j. Electric power in a restaurant

M2-13. Classifying Cost Behavior  **(LO1)**

For each of the following situations, select the most appropriate cost behavior pattern (as shown in the illustrations on the top next page) where the lines represent the cost behavior pattern, the vertical axis represents costs, the horizontal axis represents total volume, and the dots represent actual costs. Each pattern may be used more than once.

- a. Variable costs per unit
- b. Total fixed costs
- c. Total mixed costs
- d. Average fixed costs per unit
- e. Total current manufacturing costs
- f. Average variable costs
- g. Total costs when employees are paid $10 per hour for the first 40 hours worked each week and $15 for each additional hour.
- h. Total costs when employees are paid $10 per hour and guaranteed a minimum weekly wage of $200.
- i. Total costs per day when a consultant is paid $200 per hour with a maximum daily fee of $1,000.
- j. Total variable costs
- k. Total costs for salaries of social workers where each social worker can handle a maximum of 20 cases
- l. A water bill where a flat fee of $800 is charged for the first 100,000 gallons and additional water costs $0.005 per gallon
- m. Total variable costs properly used to estimate step costs
- n. Total materials costs
- o. Rent on exhibit space at a convention
M2-14. Classifying Cost Behavior (LO1)

For each of the graphs displayed at the top of page 2-24, select the most appropriate cost behavior pattern where the lines represent the cost behavior pattern, the vertical axis represents total costs, the horizontal axis represents total volume, and the dots represent actual costs. Each pattern may be used more than once.

a. A cellular telephone bill when a flat fee is charged for the first 200 minutes of use per month and additional use costs $0.45 per minute
b. Total selling and administrative costs
c. Total labor costs when employees are paid per unit produced
d. Total overtime premium paid production employees
e. Average total cost per unit
f. Salaries of supervisors when each one can supervise a maximum of 10 employees
g. Total idle time costs when employees are paid for a minimum 40-hour week
h. Materials costs per unit
i. Total sales commissions
j. Electric power consumption in a restaurant
k. Total costs when high volumes of production require the use of overtime and obsolete equipment
l. A good linear approximation of actual costs
m. A linear cost estimation valid only within the relevant range

EXERCISES

E2-15. Computing Average Unit Costs (LO2)
The total monthly operating costs of Chili To Go are:

$$10,000 + 0.40X$$

where

$$X = \text{servings of chili}$$

Required

a. Determine the average cost per serving at each of the following monthly volumes: 100; 1,000; 5,000; and 10,000
b. Determine the monthly volume at which the average cost per serving is $0.60.
E2-16. **Automatic versus Manual Processing**  (LO2)
Photo Station Company operates a printing service for customers with digital cameras. The current service, which requires employees to download photos from customer cameras, has monthly operating costs of $5,000 plus $0.20 per photo printed. Management is evaluating the desirability of acquiring a machine that will allow customers to download and make prints without employee assistance. If the machine is acquired, the monthly fixed costs will increase to $10,000 and the variable costs of printing a photo will decline to $0.04 per photo.

**Required**

a. Determine the total costs of printing 20,000 and 50,000 photos per month:
   1. With the current employee-assisted process.
   2. With the proposed customer self-service process.

b. Determine the monthly volume at which the proposed process becomes preferable to the current process.

E2-17. **Automatic versus Manual Processing**  (LO2)
Mid-Town Copy Service processes 1,800,000 photocopies per month at its mid-town service center. Approximately 50 percent of the photocopies require collating. Collating is currently performed by high school and college students who are paid $8 per hour. Each student collates an average of 5,000 copies per hour. Management is contemplating the lease of an automatic collating machine that has a monthly capacity of 5,000,000 photocopies, with lease and operating costs totaling $1,550, plus $0.05 per 1,000 units collated.

**Required**

a. Determine the total costs of collating 500,000 and 1,500,000 per month:
   1. With student help.
   2. With the collating machine.

b. Determine the monthly volume at which the automatic process becomes preferable to the manual process.

E2-18. **High-Low Cost Estimation**  (LO2)
Assume the local DHL delivery service hub has the following information available about fleet miles and operating costs:

DHL (DHL)
Year Miles Operating Costs
2010 . . . . . . . 556,000 $177,000
2011 . . . . . . . 684,000  209,000

**Required**
Use the high-low method to develop a cost-estimating equation for total annual operating costs.

**E2-19. Scatter Diagrams and High-Low Cost Estimation** *(LO2, 3)*

Assume the local *Pearle Vision* has the following information on the number of sales orders received and order-processing costs.

<table>
<thead>
<tr>
<th>Month</th>
<th>Sales Orders</th>
<th>Order-Processing Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. . . . . . .</td>
<td>3,000</td>
<td>$32,000</td>
</tr>
<tr>
<td>2. . . . . . .</td>
<td>1,500</td>
<td>22,400</td>
</tr>
<tr>
<td>3. . . . . . .</td>
<td>4,000</td>
<td>52,000</td>
</tr>
<tr>
<td>4. . . . . . .</td>
<td>2,800</td>
<td>31,200</td>
</tr>
<tr>
<td>5. . . . . . .</td>
<td>2,300</td>
<td>25,600</td>
</tr>
<tr>
<td>6. . . . . . .</td>
<td>1,000</td>
<td>16,000</td>
</tr>
<tr>
<td>7. . . . . . .</td>
<td>2,000</td>
<td>24,000</td>
</tr>
</tbody>
</table>

**Required**

a. Use information from the high- and low-volume months to develop a cost-estimating equation for monthly order-processing costs.

b. Plot the data on a scatter diagram. Using the information from representative high- and low-volume months, develop a cost-estimating equation for monthly production costs.

c. What factors might have caused the difference in the equations developed for requirements (a) and (b)?

**E2-20. Scatter Diagrams and High-Low Cost Estimation** *(LO2, 3)*

From April 1 through October 31, Knox County Highway Department hires temporary employees to mow and clean the right-of-way along county roads. The County Road Commissioner has asked you to help her in determining the variable labor cost of mowing and cleaning a mile of road. The following information is available regarding current-year operations:

<table>
<thead>
<tr>
<th>Month</th>
<th>Miles Mowed and Cleaned</th>
<th>Labor Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>April . . . . . . .</td>
<td>350</td>
<td>$8,000</td>
</tr>
<tr>
<td>May . . . . . . .</td>
<td>300</td>
<td>7,500</td>
</tr>
<tr>
<td>June . . . . . . .</td>
<td>400</td>
<td>9,000</td>
</tr>
<tr>
<td>July . . . . . . .</td>
<td>250</td>
<td>5,500</td>
</tr>
<tr>
<td>August . . . . . .</td>
<td>375</td>
<td>8,500</td>
</tr>
<tr>
<td>September . . . .</td>
<td>200</td>
<td>5,000</td>
</tr>
<tr>
<td>October . . . . .</td>
<td>100</td>
<td>4,800</td>
</tr>
</tbody>
</table>

**Required**

a. Use the information from the high- and low-volume months to develop a cost-estimating equation for monthly labor costs.

b. Plot the data on a scatter diagram. Using the information from representative high- and low-volume months, use the high-low method to develop a cost-estimating equation for monthly labor costs.

c. What factors might have caused the difference in the equations developed for requirements (a) and (b)?

d. Adjust the equation developed in requirement (b) to incorporate the effect of an anticipated 7 percent increase in wages.
E2-21. Cost Behavior Analysis in a Restaurant: High-Low Cost Estimation (LO2)

Assume a Papa John’s restaurant has the following information available regarding costs at representative levels of monthly sales:

<table>
<thead>
<tr>
<th>Monthly sales in units</th>
<th>5,000</th>
<th>8,000</th>
<th>10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of food sold</td>
<td>$10,000</td>
<td>$16,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Wages and fringe benefits</td>
<td>4,250</td>
<td>4,400</td>
<td>4,500</td>
</tr>
<tr>
<td>Fees paid delivery help</td>
<td>1,250</td>
<td>2,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Rent on building</td>
<td>1,200</td>
<td>1,200</td>
<td>1,200</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>600</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Utilities</td>
<td>500</td>
<td>560</td>
<td>600</td>
</tr>
<tr>
<td>Supplies (soap, floor wax, etc.)</td>
<td>150</td>
<td>180</td>
<td>200</td>
</tr>
<tr>
<td>Administrative costs</td>
<td>1,300</td>
<td>1,300</td>
<td>1,300</td>
</tr>
<tr>
<td>Total</td>
<td>$19,250</td>
<td>$26,240</td>
<td>$30,900</td>
</tr>
</tbody>
</table>

Required
a. Identify each cost as being variable, fixed, or mixed.
b. Use the high-low method to develop a schedule identifying the amount of each cost that is fixed per month or variable per unit. Total the amounts under each category to develop an equation for total monthly costs.
c. Predict total costs for a monthly sales volume of 9,500 units.

E2-22. Developing an Equation from Average Costs (LO2)

The America Dog and Cat Hotel is a pet hotel located in Las Vegas. Assume that in March, when dog-days (occupancy) were at an annual low of 500, the average cost per dog-day was $21. In July, when dog-days were at a capacity level of 4,000, the average cost per dog-day was $7.

Required
a. Develop an equation for monthly operating costs.
b. Determine the average cost per dog-day at an annual volume of 24,000 dog-days.

E2-23. Selecting an Independent Variable: Scatter Diagrams (LO2, 3)

Peak Production Company produces backpacks that are sold to sporting goods stores throughout the Rocky Mountains. Presented is information on production costs and inventory changes for five recent months:

<table>
<thead>
<tr>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finished goods inventory in units:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning</td>
<td>30,000</td>
<td>40,000</td>
<td>50,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Manufactured</td>
<td>60,000</td>
<td>90,000</td>
<td>80,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Available</td>
<td>90,000</td>
<td>130,000</td>
<td>130,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Sold</td>
<td>(50,000)</td>
<td>(80,000)</td>
<td>(100,000)</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Ending</td>
<td>40,000</td>
<td>50,000</td>
<td>30,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>$250,000</td>
<td>$450,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

Required
a. With the aid of scatter diagrams, determine whether units sold or units manufactured is a better predictor of manufacturing costs.
b. Prepare an explanation for your answer to requirement (a).
c. Which independent variable, units sold or units manufactured, should be a better predictor of selling costs? Why?
**E2-24. Selecting a Basis for Predicting Shipping Expenses (Requires Computer Spreadsheet*)**  \((LO2, 3)\)

Penn Company assembles and sells computer boards in western Pennsylvania. In an effort to improve the planning and control of shipping expenses, management is trying to determine which of three variables—units shipped, weight shipped, or sales value of units shipped—has the closest relationship with shipping expenses. The following information is available:

<table>
<thead>
<tr>
<th>Month</th>
<th>Units Shipped</th>
<th>Weight Shipped (lbs.)</th>
<th>Sales Value of Units Shipped</th>
<th>Shipping Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>May</td>
<td>3,000</td>
<td>6,200</td>
<td>$100,000</td>
<td>$5,500</td>
</tr>
<tr>
<td>June</td>
<td>5,000</td>
<td>8,000</td>
<td>110,000</td>
<td>7,600</td>
</tr>
<tr>
<td>July</td>
<td>4,000</td>
<td>8,100</td>
<td>80,000</td>
<td>6,500</td>
</tr>
<tr>
<td>August</td>
<td>7,000</td>
<td>10,000</td>
<td>114,000</td>
<td>10,300</td>
</tr>
<tr>
<td>September</td>
<td>6,000</td>
<td>7,000</td>
<td>140,000</td>
<td>8,500</td>
</tr>
<tr>
<td>October</td>
<td>4,500</td>
<td>8,000</td>
<td>160,000</td>
<td>8,100</td>
</tr>
</tbody>
</table>

**Required**

a. With the aid of a spreadsheet program, determine whether units shipped, weight shipped, or sales value of units shipped has the closest relationship with shipping expenses.

b. Using the independent variable that appears to have the closest relationship to shipping expenses, develop a cost-estimating equation for total monthly shipping expenses.

c. Use the equation developed in requirement (b) to predict total shipping expenses in a month when 5,000 units, weighing 7,000 lbs., with a total sales value of $114,000 are shipped.

**PROBLEMS**

**P2-25. High-Low and Scatter Diagrams with Implications for Regression**  \((LO2, 3)\)

Trumpet Bagels produces and sells bagels at each of its restaurants. Presented is monthly cost and sales information for one of Trumpet’s restaurants.

<table>
<thead>
<tr>
<th>Month</th>
<th>Sales (Dozens)</th>
<th>Total Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>8,000</td>
<td>$28,800</td>
</tr>
<tr>
<td>February</td>
<td>6,500</td>
<td>26,400</td>
</tr>
<tr>
<td>March</td>
<td>4,500</td>
<td>20,400</td>
</tr>
<tr>
<td>April</td>
<td>2,000</td>
<td>19,200</td>
</tr>
<tr>
<td>May</td>
<td>5,500</td>
<td>21,600</td>
</tr>
<tr>
<td>June</td>
<td>6,000</td>
<td>23,400</td>
</tr>
</tbody>
</table>

**Required**

a. Using the high-low method, develop a cost-estimating equation for total monthly costs.

b. 1. Plot the equation developed in requirement (a).
   2. Using the same graph, develop a scatter diagram of all observations for the bagel shop. Select representative high and low values and draw a second cost-estimating equation.

c. Which is a better predictor of future costs? Why?

d. If you decided to develop a cost-estimating equation using least-squares regression analysis, should you include all the observations? Why or why not?

e. Mention two reasons that the least-squares regression is superior to the high-low and scatter diagram methods of cost estimation.

**P2-26. Multiple Cost Drivers**  \((LO4)\)

Scottsdale Ltd. manufactures a variety of high-volume and low-volume products to customer demand. Presented is information on 2011 manufacturing overhead and activity cost drivers.

* This exercise and several subsequent assignments require the use of a computer spreadsheet such as Excel® to solve. This assignment assumes previous knowledge of computer spreadsheets.
Product X1 required 2,000 machine hours to fill 10 customer orders for a total of 8,000 units.

**Required**

a. Assuming all manufacturing overhead is estimated and predicted on the basis of machine hours, determine the predicted total overhead costs to produce the 8,000 units of product X1.

b. Assuming manufacturing overhead is estimated and predicted using separate rates for machine hours, customer orders, and products (a multiple-level cost hierarchy), determine the predicted total overhead costs to produce the 8,000 units of product X1.

c. Calculate the error in predicting manufacturing overhead using machine hours versus using multiple cost drivers. Indicate whether the use of only machine hours results in overpredicting or underpredicting the costs to produce 8,000 units of product X1.

d. Determine the error in the prediction of X1 batch-level costs resulting from the use of only machine hours. Indicate whether the use of only machine hours results in overpredicting or underpredicting the batch-level costs of product X1.

e. Determine the error in the prediction of X1 product-level costs resulting from the use of only machine hours. Indicate whether the use of only machine hours results in overpredicting or underpredicting the product-level costs of product X1.

**P2-27. Unit- and Batch-Level Cost Drivers (LO4)**

KC, a fast-food restaurant, serves fried chicken, fried fish, and French fries. The managers have estimated the costs of a batch of fried chicken for KC’s all-you-can-eat Friday Fried Fiesta. Each batch must be 100 pieces. The chicken is precut by the chain headquarters and sent to the stores in 10-piece bags. Each bag costs $3. Preparing a batch of 100 pieces of chicken with KC’s special coating takes one employee two hours. The current wage rate is $8 per hour. Another cost driver is the cost of putting fresh oil into the fryers. New oil, costing $5, is used for each batch.

**Required**

a. Determine the cost of preparing one batch of 100 pieces.

b. If management projects that it will sell 300 pieces of fried chicken, determine the total batch and unit costs.

c. If management estimates the sales to be 350 pieces, determine the total costs.

d. How much will the batch costs increase if the government raises the minimum wage to $10 per hour?

e. If management decided to reduce the number of pieces in a batch to 50, determine the cost of preparing 350 pieces. Assume that the batch would take half as long to prepare, and management wants to replace the oil after 50 pieces are cooked.

**P2-28. Optimal Batch Size (LO4)**

This is a continuation of parts “c” and “e” of P2-27.

**Required**

Should management reduce the batch size to 50? Why or why not?

**MANAGEMENT APPLICATIONS**

**MA2-29. Negative Fixed Costs (LO3)**

“This is crazy!” exclaimed the production supervisor as he reviewed the work of his new assistant.

“You and that computer are telling me that my fixed costs are negative! Tell me, how did you get these negative fixed costs, and what am I supposed to do with them?”

**Required**

Explain to the supervisor the meaning of the negative “fixed costs” and what can be done with them.
MA2-30. Significance of High R-Squared (LO3)
Oliver Morris had always been suspicious of “newfangled mathematical stuff,” and the most recent suggestion of his new assistant merely confirmed his belief that schools are putting a lot of useless junk in students’ heads. It seems that after an extensive analysis of historical data, the assistant suggested that the number of pounds of scrap was the best basis for predicting manufacturing overhead. In response to Mr. Morris’s rage, the slightly intimidated assistant indicated that of the 35 equations he tried, pounds of scrap had the highest coefficient of determination with manufacturing overhead.

Required
Comment on Morris’s reaction. Is it justified? Is it likely that the number of pounds of scrap is a good basis for predicting manufacturing overhead? Is it a feasible basis for predicting manufacturing overhead?

In an attempt to determine the best basis for predicting machine repair costs, the production supervisor accumulated daily information on these costs and production over a one-month period. Applying simple regression analysis to the data, she obtained the following estimating equation:

\[ Y = 800 - 2.601X \]

where

- \( Y \) = total daily machine repair costs
- \( X \) = daily production in units

Because of the negative relationship between repair costs and production, she was somewhat skeptical of the results, even though the R-squared was a respectable 0.765.

Required
a. What is the most likely explanation of the negative variable costs?

b. Suggest an alternative procedure for estimating machine repair costs that might prove more useful.

MA2-32. Ethical Problem Uncovered by Cost Estimation (LO3)
Phoenix Management Company owns and provides management services for several shopping centers. After five years with the company, Mike Moyer was recently promoted to the position of manager of X-Town, an 18-store mall on the outskirts of a downtown area. When he accepted the assignment, Mike was told that he would hold the position for only a couple of years because X-Town would likely be torn down to make way for a new sports stadium. Mike was also told that if he did well in this assignment, he would be in line for heading one of the company’s new 200-store operations that were currently in the planning stage.

While reviewing X-Town’s financial records for the past few years, Mike observed that last year’s oil consumption was up by 8 percent, even though the number of heating degree days was down by 4 percent. Somewhat curious, Mike uncovered the following information:
- X-Town is heated by forced-air oil heat. The furnace is five years old and has been well maintained.
- Fuel oil is kept in four 5,000-gallon underground oil tanks. The oil tanks were installed 25 years ago.
- Replacing the tanks would cost $80,000. If pollution was found, cleanup costs could go as high as $2,000,000, depending on how much oil had leaked into the ground and how far it had spread.
- Replacing the tanks would add more congestion to X-Town’s parking situation.

Required
What should Mike do? Explain.

MA2-33. Activity Cost Drivers and Cost Estimation (LO3, 4)
Blue Ridge Ice Cream Company produces ten varieties of ice cream in large vats, several thousand gallons at a time. The ice cream is distributed to several categories of customers. Some ice cream is packaged in large containers and sold to college and university food services. Some is packaged in half-gallon or small containers and sold through wholesale distributors to grocery stores. Finally, some is packaged in a variety of individual servings and sold directly to the public from trucks owned and
operated by Blue Ridge. Management has always assumed that costs fluctuated with the volume of ice cream, and cost-estimating equations have been based on the following cost function:

\[
\text{Estimated costs} = \text{Fixed costs} + \text{Variable costs per gallon} \times \text{Production in gallons}
\]

Lately, however, this equation has not been a very accurate predictor of total costs. At the same time, management has noticed that the volumes and varieties of ice cream sold through the three distinct distribution channels have fluctuated from month to month.

Required
a. What relevant major assumption is inherent in the cost-estimating equation currently used by Blue Ridge?
b. Why might Blue Ridge wish to develop a cost-estimating equation that recognizes the hierarchy of activity costs? Explain.
c. Develop the general form of a more accurate cost-estimating equation for Blue Ridge. Clearly label and explain all elements of the equation, and provide specific examples of costs for each element.

MA2-34. Multiple Regression Analysis for a Special Decision (Requires Computer Spreadsheet) \((\text{LO2, 3})\)
For billing purposes, Central City Health Clinic classifies its services into one of four major procedures, \(X_1\) through \(X_4\). A local business has proposed that Central City provide health services to its employees and their families at the following set rates per procedure:

\[
\begin{align*}
X_1 & \quad \text{. . . . . . $45} \\
X_2 & \quad \text{. . . . . . 90} \\
X_3 & \quad \text{. . . . . . 60} \\
X_4 & \quad \text{. . . . . . 105}
\end{align*}
\]

Because these rates are significantly below the current rates charged for these services, management has asked for detailed cost information on each procedure. The following information is available for the most recent 12 months.

<table>
<thead>
<tr>
<th>Month</th>
<th>Total Cost</th>
<th>Number of Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(X_1)</td>
</tr>
<tr>
<td>1</td>
<td>$23,000</td>
<td>30</td>
</tr>
<tr>
<td>2</td>
<td>25,000</td>
<td>38</td>
</tr>
<tr>
<td>3</td>
<td>27,000</td>
<td>50</td>
</tr>
<tr>
<td>4</td>
<td>19,000</td>
<td>20</td>
</tr>
<tr>
<td>5</td>
<td>20,000</td>
<td>67</td>
</tr>
<tr>
<td>6</td>
<td>27,000</td>
<td>90</td>
</tr>
<tr>
<td>7</td>
<td>25,500</td>
<td>20</td>
</tr>
<tr>
<td>8</td>
<td>21,500</td>
<td>15</td>
</tr>
<tr>
<td>9</td>
<td>26,000</td>
<td>60</td>
</tr>
<tr>
<td>10</td>
<td>22,000</td>
<td>20</td>
</tr>
<tr>
<td>11</td>
<td>22,800</td>
<td>20</td>
</tr>
<tr>
<td>12</td>
<td>26,500</td>
<td>72</td>
</tr>
</tbody>
</table>

Required
a. Use multiple regression analysis to determine the unit cost of each procedure. How much variation in monthly cost is explained by your cost-estimating equation?
b. Evaluate the rates proposed by the local business. Assuming Central City has excess capacity and no employees of the local business currently patronize the clinic, what are your recommendations regarding the proposal?
c. Evaluate the rates proposed by the local business. Assuming Central City is operating at capacity and would have to turn current customers away if it agrees to provide health services to the local business, what are your recommendations regarding the proposal?

MA2-35. Cost Estimation, Interpretation, and Analysis (Requires Computer Spreadsheet) \((\text{LO2, 3})\)
Piedmont Table Company produces two styles of tables, dining room and kitchen. Presented is monthly information on production volume and manufacturing costs:
### Required

\( a \). Use the high-low method to develop a cost-estimating equation for total manufacturing costs. Interpret the meaning of the “fixed” costs and comment on the results.

\( b \). Use the chart feature of a spreadsheet to develop a scatter graph of total manufacturing costs and total units produced. Use the graph to identify any unusual observations.

\( c \). Excluding any unusual observations, use the high-low method to develop a cost-estimating equation for total manufacturing costs. Comment on the results, comparing them with the results in requirement (a).

\( d \). Use simple regression analysis to develop a cost-estimating equation for total manufacturing costs. What advantages does simple regression analysis have in comparison with the high-low method of cost estimation? Why must analysts carefully evaluate the data used in simple regression analysis?

\( e \). A customer has offered to purchase 50 dining room tables for $220 per table. Management has asked your advice regarding the desirability of accepting the offer. What advice do you have for management? Additional analysis is required.

### MA2-36. Simple and Multiple Regression (Requires Computer Spreadsheet) (LO2, 3)

Kevin Miller is employed by a mail-order distributor and reconditions used desktop computers, broadband routers, and laser printers. Kevin is paid $12 per hour, plus an extra $6 per hour for work in excess of 40 hours per week. The distributor just announced plans to outsource all reconditioning work. Because the distributor is pleased with the quality of Kevin’s work, he has been asked to enter into a long-term contract to recondition used desktop computers at a rate of $40 per computer, plus all parts. The distributor also offered to provide all necessary equipment at a rate of $200 per month. Kevin has been informed that he should plan on reconditioning as many computers as he can handle, up to a maximum of 20 per week.

Kevin has room in his basement to set up a work area, but he is unsure of the economics of accepting the contract, as opposed to working for a local Radio Stuff store at $11 per hour. Data related to the time spent and the number of units of each type of electronic equipment Kevin has reconditioned in recent weeks is as follows:
<table>
<thead>
<tr>
<th>Week</th>
<th>Laser Printers</th>
<th>Broadband Routers</th>
<th>Desktop Computers</th>
<th>Total Units</th>
<th>Total Hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>14</td>
<td>40</td>
</tr>
<tr>
<td>2</td>
<td>0</td>
<td>7</td>
<td>6</td>
<td>13</td>
<td>42</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
<td>3</td>
<td>7</td>
<td>14</td>
<td>40</td>
</tr>
<tr>
<td>4</td>
<td>0</td>
<td>2</td>
<td>12</td>
<td>14</td>
<td>46</td>
</tr>
<tr>
<td>5</td>
<td>11</td>
<td>6</td>
<td>4</td>
<td>21</td>
<td>48</td>
</tr>
<tr>
<td>6</td>
<td>5</td>
<td>8</td>
<td>3</td>
<td>16</td>
<td>44</td>
</tr>
<tr>
<td>7</td>
<td>5</td>
<td>8</td>
<td>3</td>
<td>16</td>
<td>44</td>
</tr>
<tr>
<td>8</td>
<td>5</td>
<td>6</td>
<td>5</td>
<td>16</td>
<td>43</td>
</tr>
<tr>
<td>9</td>
<td>2</td>
<td>6</td>
<td>10</td>
<td>18</td>
<td>53</td>
</tr>
<tr>
<td>10</td>
<td>8</td>
<td>4</td>
<td>6</td>
<td>18</td>
<td>46</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>160</td>
<td>446</td>
</tr>
</tbody>
</table>

**Required**

Assuming he wants to work an average of 40 hours per week, what should Kevin do?