CVP ANALYSIS

Prestige Telephone Company

In April 2003, Daniel Rowe, president of Prestige Telephone Company, was preparing for a meeting with Susan Bradley, Manager of Prestige Data Services, a company subsidiary. Partial deregulation and an agreement with the state Public Service Commission had permitted Prestige Telephone to establish a computer data service subsidiary to perform data processing for the telephone company and to sell computer service to other companies and organizations. Mr. Rowe had told the commission in 1999 that a profitable computer services subsidiary would reduce pressure for telephone rate increases. However, by the end of 2002 the subsidiary had yet to experience a profitable month. Ms. Bradley felt only more time was needed, but Rowe felt action was necessary to reduce the drain on company resources.

Prestige Data Services had grown out of the needs of Prestige Telephone for computer services to plan, control, and account for its own operations in the metropolitan region it served. The realization by Prestige that other businesses in the metropolitan region needed similar services and that centralized service could be provided over telephone circuits suggested that Prestige could sell computer time not needed by telephone operations. In addition, the state Public Service Commission had encouraged all public utilities under its jurisdiction to seek new sources of revenue and profits as a step toward deregulation and to reduce the need for rate increases which higher costs would otherwise bring.

Because it operated as a public utility, the rates charged by Prestige Telephone Company for telephone service could not be changed without the approval of the Public Service Commission. In presenting the proposal for the new subsidiary, Mr. Rowe had argued for a separate but wholly owned entity whose prices for service would not be regulated. In this way, Prestige could compete with other computer service organizations in a dynamic field; in addition, revenues for use of telephone services might also be increased. The commission accepted this proposal subject only to the restriction that the average monthly charge for service, by the subsidiary to the parent, not exceed $82,000, the estimated cost of equivalent services used by Prestige Telephone Company in 1999. All accounts of Prestige Data Services were separated from those of Prestige Telephone, and each paid the other for services received from the other.

From the start of operations of Prestige Data Services in 2000 there had been problems. Equipment deliveries were delayed. Personnel had commanded higher salaries than expected. And most important, customers were harder to find than earlier estimates had led the company to expect. By the end of 2002, when income of Prestige Telephone was low enough to necessitate a report to shareholders revealing the lowest return on investment in seven years, Rowe felt it was time to reassess Prestige Data Services. Susan Bradley asked for more time, as she felt the subsidiary would be profitable by March. But when the quarterly reports came (Exhibits 1 and 2), Rowe called Bradley to arrange their meeting.

Rowe received two reports on operations of Prestige Data Services. The Summary of Computer Utilization (Exhibit 1) summarized the use of available hours of computer time. Service was

offered to commercial customers 24 hours a day on weekdays and eight hours on Saturdays. Routine maintenance of the computers was provided by an outside contractor who took the computer off line for eight hours each week for testing and upkeep:. The reports for the quarter revealed a persistent problem; available hours,
which did not provide revenue, remained high.

Revenue and cost data were summarized in the quarterly report on results of operations (Exhibit 2). Intra-company work was billed at $400 per hour, a rate based on usage estimates for 2000 and the Public Service Commission's restrictions that cost to Prestige Telephone should not exceed an average of $82,000 per month. Commercial sales were billed at $800 per hour.

While most expenses summarized in the report were self explanatory, Rowe reminded himself of the characteristics of a few. Space costs were all paid to Prestige Telephone. Prestige Data Services rented the ground floor of a central exchange building owned by the company for $8,000 per month. In addition, a charge for custodial service based on the estimated annual cost per square foot was paid by Data Services, as Telephone personnel provided these services.

Computer equipment had been acquired by lease and by purchases; leases had four years to run and were non-cancelable. Owned equipment was all salable but probably could not bring more than its book value in the used equipment market.

Wages and salaries were separated in the report to show the expense of four different kinds of activities. Operating salaries included those of the six persons necessary to run the center around the clock well as amounts paid hourly help who were required when the computer was in operation. Salaries of the programming staff who provided service to clients and maintained the operating system were reported as system development and maintenance. Sales personnel, who called upon and serviced present and prospective commercial clients, were also salaried..

Because of its relationship with Prestige Telephone, Prestige Data Services was able to avoid many costs an independent company would have. For example, all payroll, billing, collections, and accounting were done by telephone company personnel. For those corporate services, Prestige Data Services paid Prestige Telephone an amount based on wages and salaries each month.

Although Rowe was discouraged by results to date, he was reluctant to suggest to Bradley that Prestige Data Services be closed down or sold. The idea behind the subsidiary just seem too good to give up easily. Besides, he was not sure that the accounting report really revealed the contribution that Data Services was making to Prestige Telephone. In other cases, he felt that the procedures used in accounting for separate activities in the company tended to obscure the costs and benefits they provided.

After examining the reports briefly, Rowe resolved to study them in preparation for asking Bradley to estimate the possible effects on profits of increasing the price to customers other than Prestige Telephone, reducing prices, increasing sales efforts and promotion, and of going to two-shift rather than 24-hour operations.

Requirements:

1. Evaluate the results of operations of Prestige Data Services (Exhibits 1 and 2 are attached). Is the subsidiary really a problem to Prestige Telephone Company?
2. Briefly analyze the cost behavior of the revenues and expenses for Prestige Data.
3. Assume a variable cost of $28 per hour, commercial revenues of $800 per hour and fixed costs of $115,820. Also, assume actual utilization of 138 hours - this is what is given in Exhibit 1 for March. (Please ignore any intercompany effects for this question).
   a) What is the break even volume (hours)?
   b) Estimate the effect on income of each of the options Rowe has suggested if Bradley estimates as follows:
      i) Increasing the price to commercial customers to $1,000 per hours would reduce demand by 30%.
      ii) Reducing the price to commercial customers to $600 per hour would increase demand by 30%.
      iii) Reducing operations to 16 hours on weekdays and eight hours on Saturdays would result in a loss of 20% of commercial revenue hours.
      iv) If increased promotion would increase sales by 30%, how much can be spent each month without reducing income?
4. What specific suggestions for improving the accounting system and report format would you suggest to Rowe and Bradley so that they might more easily understand how well Prestige Data is performing?

Reference:

www.utdallas.edu/~nataraj/.../**prestige**-4343-additional%20notes.doc

Exhibit 1 Prestige Data Services Summary of Computer Utilization, First Quarter 2003

Revenue Hours	January	February	March
Intercompany	206	181	223
Commercial	123	135	138
Total revenue hours	329	316	361
Service hours	32	32	40
Available hours	223	164	143
Total hours	584	512	544

Exhibit 2 Prestige Data Services Summary Results of Operations, First Quarter 2003

	January	February	March
Revenues			
Intercompany sales	$82,400	$72,400	$89,200
Commercial sales			
Computer use	98,400	108,000	110,400
Other	9,241	9,184	12,685
Total revenue	$190,041	$189,584	$212,285
Expenses			
Space costs:			
Rent	$8,000	$8,000	$8,000
Custodial services	1,240	1,240	1,240
	9,240	9,240	9,240
Equipment costs			
Computer leases	95,000	95,000	95,000
Maintenance	5,400	5,400	5,400
Depreciation:			
Computer equipment	25,500	25,500	25,500
Office equipment and fixtures	680	680	680
Power	1,633	1,592	1,803
	128,213	128,172	128,383
Wages and salaries			
Operations	29,496	29,184	30,264
Systems development and maintenance	12,000	12,000	12,000
Administration	9,000	9,000	9,000
Sales	11,200	11,200	11,200
	61,696	61,384	62,464/
Materials	9,031	8,731	10,317
Sales promotions	7,909	7,039	8,083
Corporate services	15,424	15,359	15,236
Total expenses	$231,513	$229,925	$233,723
Net income (loss)	$(41,472)	$(40,341)	$(21,438)