

Answer on Question #64295 - Economics - Accounting

Mills Inc. manufactures 50,000 components per year. The manufacturing cost per unit of the components is as follows:

Direct materials	\$ 12
Direct labor	13
Variable overhead	5
Fixed overhead	<u>10</u>
Total unit cost	<u>\$40</u>

An outside supplier has offered to sell the component to Mills Inc. for \$35

Required:

- What is the effect on income if Mills Inc. purchases the component from the outside supplier?
- Assume that Mills Inc. can avoid \$700,000 of the total fixed overhead costs if it purchases the components. Now what is the effect on income if Mills Inc. purchases the component from the outside supplier?

Answer:

- To answer this assumption conduct analysis for decision-making "make or buy" 50,000 components.

Indicator	Cost per unit, \$	Relevant costs per unit, \$		General relevant costs, \$	
		make	buy	make	buy
Direct materials	12	12		600000	
Direct labor	13	13		650000	
Variable overhead	5	5		250000	
Fixed overhead	10				
The cost of the acquisition component	-		35		1750000
Total	40	30	35	1500000	1750000
Differential costs		5		250000	

As you can see, is irrelevant fixed costs which can not be avoided in case of purchase components. Thus, the relevant components manufacturing cost is \$ 30 which is \$ 5 less than the cost of their purchase. We can conclude that the company is more profitable to produce components than buying them from the outside supplier.

b) Consider the situation in the light opportunities to reduce fixed costs by purchasing components, then, considering the alternative to "make or buy", given the benefits that the company will lose by continuing production of components instead of purchasing them.

Thus, the relevant production cost component for decision is:

Valid relevant production costs + Opportunity cost

Opportunity costs to attribute differences in fixed costs in the amount of \$200,000 (700000-10 * 50000). Based on initial data obtained results:

Analysis for decision taking into account the lost opportunities, \$

Costs	Make	Buy
Valid relevant production costs	1 500 000	1 750 000
Opportunity cost	200 000	—
Total	1 700 000	1 750 000
Differential costs	50 000	

In this case also advantageous to produce their own components.

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