

PROBLEM 3-28 Graphing; Incremental Analysis; Operating Leverage [LO 3-2, LO 3-4, LO 3-5, LO 3-6, LO 3-8]

Teri Hall has recently opened Sheer Elegance, Inc., a store specializing in fashionable stockings. Ms. Hall has just completed a course in managerial accounting, and she believes that she can apply certain aspects of the course to her business. She is particularly interested in adopting the cost-volume-profit (CVP) approach to decision making. Thus, she has prepared the following analysis:

Sales price per pair of stockings	\$2.00
Variable expense per pair of stockings	0.80
Contribution margin per pair of stockings	<u>\$1.20</u>
Fixed expense per year:	
Building rental	\$12,000
Equipment depreciation	3,000
Selling	30,000
Administrative	<u>15,000</u>
Total fixed expense	<u>\$60,000</u>

Required:

- How many pairs of stockings must be sold to break even? What does this represent in total dollar sales?
- Prepare a CVP graph or a profit graph for the store from zero pairs up to 70,000 pairs of stockings sold each year. Indicate the break-even point on the graph.
- How many pairs of stockings must be sold to earn a \$9,000 target profit for the first year?
- Ms. Hall now has one full-time and one part-time salesperson working in the store. It will cost her an additional \$8,000 per year to convert the part-time position to a full-time position. Ms. Hall believes that the change would bring in an additional \$20,000 in sales each year. Should she convert the position? Use the incremental approach. (Do not prepare an income statement.)
- Refer to the original data. Actual operating results for the first year are as follows:

Sales	\$125,000
Variable expenses	<u>50,000</u>
Contribution margin	75,000
Fixed expenses	<u>60,000</u>
Net operating income	<u>\$ 15,000</u>

- What is the store's degree of operating leverage?
- Ms. Hall is confident that with some effort she can increase sales by 20% next year. What would be the expected percentage increase in net operating income? Use the degree of operating leverage concept to compute your answer.