"sense" under absorption costing.

CASE 7–20 Ethics and the Manager; Absorption Costing Income Statements [LO2, LO4]

Guochang Li was hired as chief executive officer (CEO) in late November by the board of directors of ContactGlobal, a company that produces an advanced global positioning system (GPS) device. The previous CEO had been fired by the board of directors due to a series of shady business practices including shipping defective GPS devices to dealers.

Guochang felt that his first priority was to restore employee morale—which had suffered during the previous CEO's reign. He was particularly anxious to build a sense of trust between himself and the company's employees. His second priority was to prepare the budget for the coming year, which the board of directors wanted to review in their December 15 meeting.

After hammering out the details in meetings with key managers, Guochang was able to put together a budget that he felt the company could realistically meet during the coming year. That budget appears below:

Basic budget data	
Units in beginning inventory	0
Units produced	400,000
Units sold	400,000
Units in ending inventory	0
Variable costs per unit:	
Direct materials	$ 57.20
Direct labor	15.00
Variable manufacturing overhead	5.00
Variable selling and administrative	10.00
Total variable cost per unit	$ 87.20
Fixed costs:	
Fixed manufacturing overhead	$ 6,888,000
Fixed selling and administrative	4,560,000
Total fixed costs	$11,448,000

CONTACTGLOBAL Budgeted Income Statement (absorption method)		
Sales (400,000 units × $120 per unit)		$48,000,000
Less cost of goods sold:		
Beginning inventory	$ 0	
Add cost of goods manufactured		
(400,000 units × $94.42 per unit)	37,768,000	
Goods available for sale	37,768,000	
Less ending inventory	0	37,768,000
Gross margin		10,232,000
Less selling and administrative expenses:		
Variable selling and administrative		
(400,000 units × $10 per unit)	4,000,000	
Fixed selling and administrative	4,560,000	8,560,000
Net operating income		$ 1,672,000

The board of directors made it clear that this budget was not as ambitious as they had hoped. The most influential member of the board stated that "managers should have to stretch to meet profit goals." After some discussion, the board decided to set a profit goal of $2,000,000 for the coming year. To provide strong incentives, the board agreed to pay out very substantial bonuses to top managers of $10,000 to $25,000 each if this profit goal was eventually met. The bonus would be all-or-nothing. If actual net operating income turned out to be $2,000,000 or more, the bonus would be paid. Otherwise, no bonus would be paid.