WINDSTREAM SERVICES

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This case provides a framework to discuss many of the concepts in cost or management accounting. Flexibility is available to limit the focus of the case to a review of cost behavior and cost allocation or to expand the discussion to include cost behavior, cost allocation, incremental decision making, performance evaluation, and transfer pricing. These opportunities are highlighted in the case teaching notes. This case can be used effectively as a capstone in a first-semester undergraduate or graduate cost management course or to review these concepts in an advanced (second-semester) cost or management accounting course.

INTRODUCTION

In April, 2018, Bart Blue, president of NorthTel Telecom a regional telecom company, was preparing for a meeting with April East, manager of WindStream Network Services, a NorthTel subsidiary. After agreement with state regulators, WindStream was formed to provide knowledge management services to NorthTel and other telecom companies across the country. Blue had promised the NorthTel board of directors that WindStream would provide dependable service to NorthTel and bolster NorthTel earnings by providing service to outside telecoms. However, the market has proven to be more competitive than expected and WindStream had yet to show a profitable month. East felt that more time was needed, but Blue was demanding action to reduce WindStream's drain on NorthTel resources.

Company background

WindStream had grown out of the needs of NorthTel for low-cost knowledge management services, a difficult task for large and small telecom firms. WindStream provides information management tools and enabling technologies, including Internet-based user interfaces, commercial software, and workflow management systems. Service offerings enable clients to standardize and improve the way they manage system life cycles, products, and material assets. These services include prototype development and integration, software design, and analytical and collaborative tools.

By providing services to other firms in the industry, Blue expected that WindStream would provide a new source of revenues and profits to allow NorthTel to be a low-cost utility provider in its metropolitan area and region. WindStream operates as an application service provider (ASP). Customers link to WindStream servers to access the system and are charged for each hour of service used.

From the start of operations 4 years ago, there had been problems at WindStream. Equipment deliveries were delayed and personnel salaries were higher than expected. Most important, customers had been harder to find than earlier estimates had led NorthTel's senior management to expect. Thus, Blue felt that it was necessary to reassess the viability of WindStream. East had asked for more time, but when first quarter results were released, Blue requested a meeting with East.

Performance measurement

Two reports were available to Blue on WindStream operations, as shown in exhibits 1 and 2. A summary of processing hours is provided in exhibit 1. Service was offered to customers 24 hours per day on weekdays and 8 hours on Saturday. The report for the quarter showed a persistent problem, available processing hours, which did not provide revenue, remained high.

A summary of revenue and cost data was provided in exhibit 2. Intracompany work was billed at $400 per hour, as specified in the contract for WindStream services. The contract restricted WindStream to charging no more than $92,000 to NorthTel per month. The maximum contract level of intra-company service had never been exceeded and little change was expected in the level of WindStream service needed by NorthTel. Renegotiation of WindStream’s contract with NorthTel was not permitted. Commercial sales to outside customers were billed at $800 per processing hour.

Most of the charges shown in exhibit 2 were self-explanatory. Much of WindStream’s cost was fixed with respect to hours of service. Variable cost was incurred during operating hours which include revenue and service hours only. Routine system maintenance was provided by WindStream staff who periodically took the system offline for testing and maintenance. System maintenance time was shown in exhibit 1 as service hours.

Occupancy cost represented payments to NorthTel for space in NorthTel’s central office building. The building was owned by NorthTel and it provided space for various NorthTel administrative activities as well as WindStream employees who occupied space in several areas of the building. NorthTel also charged WindStream for custodial services provided by NorthTel’s maintenance staff. Occupancy charges were based on the proportion of square footage occupied by WindStream.

Computer equipment had been acquired by lease and purchase. Leases had four years to run and were non-cancelable. Owned equipment was all salable and would probably bring about book value in the used equipment market.

Wages and salaries shown in the report reflected four kinds of activities. Operating salaries included technicians who ran the equipment during operating hours and worked when the system was in operation (during revenue and service hours). Salaries of programming staff, who maintained the operating system were reported as systems development. Sales personnel were salaried. They serviced and called upon present and prospective clients, including NorthTel.

Because of its relationship with NorthTel, WindStream was able to avoid some of the costs that would be incurred by an independent company. Payroll, billing, collections, and accounting were done by NorthTel. These services were charged to WindStream based its proportion of wages and salaries to total NorthTel wages and salaries.

Although East was discouraged by the results shown in exhibits 1 and 2, she was reluctant to accept that WindStream should be closed or sold. She was convinced that WindStream provided value to the organization. However, she was frustrated that the accounting reports failed to appropriately reflect what she believed to be a substantial contribution that WindStream was making to NorthTel. Blue was similarly discouraged by the results shown in exhibits 1 and 2. He felt that the idea behind the subsidiary seemed good and it was difficult to abandon it easily.

Operational changes

After examining the latest results, Blue resolved to ask East for alternatives to increase WindStream earnings. He thought that price increases, cost reductions, and sales promotions may be needed to save the subsidiary. Blue wondered about the financial effect of the following specific changes for WindStream.

1. Increasing or reducing the hourly rate (price) to commercial customers.

2. Increasing promotion efforts. Blue was unsure about the cost.

3. Reducing operations to two shifts (16 hours) on weekdays and 8 hours on Saturdays.

Blue proposed the above changes to East and awaited her input at the upcoming meeting. Meanwhile, to prepare her recommendations, East asked for input from the WindStream Controller’s Division and Marketing Department. She obtained the following.

1. Increasing the price to commercial customers to $1,000 per hour would reduce demand by 30.0%.

2. Reducing the price to commercial customers to $600 per hour would increase demand by 30.0%.

3. The marketing department estimated that potential increased sales from increased promotion would be about 30.0%. However they were unable to predict how much promotion spending would be required for such a sales increase.

4. Reduced hours of operations as suggested by Blue would result in a 20.0% loss of business.

EXHIBIT 1
WindStream
Summary of service hours
Quarter 1, 2018

	Jan	Feb	Mar
intracompany	206	181	223
commercial	123	135	138
revenue hours	329	316	361
service hours	32	32	40
available hours	199	164	143
total hours	560	512	544

EXHIBIT 2
WindStream Inc.
Summary of operations
Quarter 1, 2018

	Jan	Feb	March
knowledge management	$98,400	$108,000	$110,400
other	9,241	9,184	12,685
commercial	107,641	117,184	123,085
intracompany	82,400	72,400	89,200
total revenue	$190,041	$189,584	$212,285
rent	8,000	8,000	8,000
custodial	1,240	1,240	1,240
occupancy	$9,240	$9,240	$9,240
computer leases	68,000	68,000	68,000
maintenance	5,400	5,400	5,400
computer equip depr.	25,500	25,500	25,500
office equip depr.	680	680	680
power	17,300	16,700	18,900
equipment cost	$116,880	$116,280	$118,480
operations	29,850	28,900	33,100
systems development	12,000	12,000	12,000
administration	9,000	9,000	9,000
sales	11,200	11,200	11,200
wages and salaries	$62,050	$61,100	$65,300
materials	9,031	8,731	10,317
sales promotions	7,909	7,039	8,083
corporate services	15,424	15,359	15,236
expenses	$220,534	$217,749	$226,656
income	$-30,493	$-28,165	$-14,371